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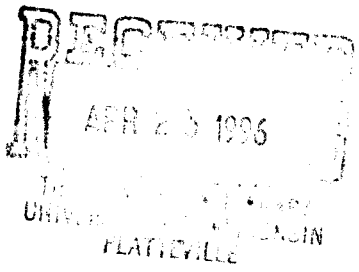

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THE CONTRIBUTORS

THOMAS A. BAYLIS is Professor of Political Science at the University of Texas at San Antonio. He is author of *Governing by Committee: Collegial Leadership in Advanced Societies* (1989) and *The West and Eastern Europe: Economic Statecraft and Political Change* (1994). His current research interests include the relationship between elite and institutional change in East Central Europe.

MARK HALLERBERG is Assistant Professor at the School of International Affairs, Georgia Institute of Technology. He is currently working on a project that examines how increasing economic integration constrains policymakers within the European Union. He is also interested in game-theoretic models of the budget process in modern democracies.

CATHERINE C. LANGLOIS is Assistant Professor of Economics at Georgetown University's School of Business. Her current research interests focus on trade policy and business practices, as they develop in the wider context of international relations.

JEAN-PIERRE P. LANGLOIS is Professor of Mathematics at San Francisco State University. His research focuses on the game-theoretic modeling of international relations. He is currently designing computer software and writing a companion book for game theory.

JEFFREY KOPSTEIN is Assistant Professor of Political Science at the University of Colorado at Boulder. He is the author of *The Politics of Economic Decline in East Germany, 1945–1989* (forthcoming) and is currently on leave as a Conant Fellow at the Center for European Studies, Harvard University.

DALI L. YANG is Assistant Professor of Political Science at the University of Chicago. He is the author of *Calamity and Reform in China* (1996), which explores the causes of the worst famine in human history and its implications for Chinese reforms. His current research projects deal with the politics of industrial development and the political economy of regional disparities.

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ABSTRACTS

Presidents versus Prime Ministers

Shaping Executive Authority in Eastern Europe

By THOMAS A. BAYLIS

Open conflict between presidents and prime ministers has become a familiar phenomenon throughout East Central Europe since the fall of communism. While individual personalities and the particular constellations of issues in each country have helped shape individual conflicts, this article seeks to account for them in more fundamental structural terms and to place them in the context of current debates over the relative virtues of presidentialism and parliamentarism. There is a discrepancy between the prestige and popularity of presidents and their modest formal powers; prime ministers, by contrast, enjoy considerable formal power but only limited legitimacy. Since the distribution of authority in newly constituted democracies is ambiguous and fluid, with no established conventions and understandings defining precisely the boundaries among key institutions, presidents seek to utilize the ambiguity to convert their assets of prestige into "real" power over policy, while prime ministers resist what they see as incursions into their areas of responsibility. The article explores the strengths and weaknesses of each side, the terrain of struggle, the tactics employed, the political outcomes to date, and the implications for political consolidation and the future distribution of executive authority in the region's states.

Tax Competition in Wilhelmine Germany and Its Implications for the European Union

By MARK HALLERBERG

The twenty-five German states from 1871 to 1914 present a useful data set for examining how increasing economic integration affects tax policy. After German unification the national government collapsed six currencies into one and liberalized preexisting restrictions on capital and labor mobility. In contrast, the empire did not directly interfere in the making of state tax policy; while states transferred certain indirect taxes to the central government, they maintained their own autonomous tax and political systems through World War I. This paper examines the extent to which tax competition forced the individual state tax systems to converge from 1871 to 1914. In spite of a diversity of political systems, tax competition did require states to harmonize their rates on mobile factors like capital and high income labor, but it did not affect tax rates on immobile factors. In states where the political system guaranteed agricultural dominance, taxes on land were reduced, while in states with more open systems, tax rates remained higher. One unexpected result is that tax rates on capital and income converged upward instead of downward. The most dominant state, Prussia, served as the lowest-common-denominator state, but pressure from the national government, especially to increase expenditures, forced all states to raise their tax rates. These results suggest possible ways for the European Union to avoid a forced downward convergence of member state tax rates on capital and mobile labor.

Rationality in International Relations

A Game-Theoretic and Empirical Study of the U.S.-China Case

By CATHERINE C. LANGLOIS and JEAN-PIERRE P. LANGLOIS

This paper develops a model of rational behavior that is found to be compatible with the evolution of China-U.S. relations from the early 1970s to the late 1980s. The authors introduce countervailing strategies that broaden our understanding of what is rational in a game-theoretic context. Countervailing behavior accommodates inertia and delay, as well as reactivity, and is shown to be involved in every equilibrium strategy. The terms of the interaction between the United States and China are identified in light of a countervailing model, and the payoff structure that supports the observed dynamic interaction is inferred. Prior to 1979, which marks the inception of China's open-door policy, the payoff structure found conforms to a little-known mixed-motive game, whereas the 1980s are characterized by a Prisoner's Dilemma. In the 1980s rational play involves positive reactivity on the part of each country, while prior to 1979 rational

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behavior on the part of the U.S. takes the form of an inverse response to Chinese initiatives, a behavior that draws its rationality from its ability to move China to a more cooperative stance despite a Deadlock-type payoff structure.

Chipping Away at the State

Workers' Resistance and the Demise of East Germany

By JEFFREY KOPSTEIN

This article is a study of everyday resistance and political protest among East German workers under communism. It develops and adduces evidence for two hypotheses based on evidence from Communist Party and state archives. First, in contrast to the standard explanation for the revolution of 1989, which emphasizes intellectual and popular mobilization against the regime, this essay emphasizes the long-term capacity of otherwise powerless workers to immobilize the regime through nonpolitical acts of everyday resistance. This resistance, coupled with the rare act of political protest, rendered ineffective the conventional methods of labor discipline and undermined any hope of meaningful economic reform. The second hypothesis concerns the motivation for working-class behavior. Two models of social action have dominated studies of subalterns: rational choice and moral economy. The models are evaluated against the archival record. While the evidence is not overwhelmingly in favor of either model, the moral economy approach provides a better account of the sporadic acts of rebellion and the myriad acts of everyday resistance.

Governing China's Transition to the Market

Institutional Incentives, Politicians' Choices, and Unintended Outcomes

By DALI L. YANG

This essay reviews two books that seek to account for China's success in making economic reforms and sustaining rapid growth. One perspective explains China's reformist approach in terms of politicians making choices under certain institutional rules. The other sees an economic logic of market transition and emphasizes policymakers' limited abilities in governing the economy. The essay assesses the merits of these competing claims. It calls for better specification of the causal linkages between institutional rules and politicians' choices and concludes that both the dynamics and dilemmas of China's political economy are explained in terms of increasing market competition. Finally the essay evaluates the argument that decentralization leads to market segmentation and points to the Chinese government's evolving role in dealing with the economy.

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PRESIDENTS VERSUS PRIME MINISTERS
Shaping Executive Authority in Eastern Europe

By THOMAS A. BAYLIS*

> If the constitution is "so deformed" that it will not allow the president to be the prime minister of the government, Lech Wałęsa declares that "many people" including himself, will not agree to that. He argued that he does not want great power, but the possibility of making quick decisions.
>
> —*Rzeczpospolita, February 26–27, 1994, reporting on Wałęsa news conference*[1]

> Well, our president says various things. Sometimes they border on a kind of a black humor. Poles have managed to get used to this; some get irritated, look at their wristwatches, and look forward to the end of this term of office; others are delighted.
>
> —*Leszek Miller, labor and social policy minister*[2]

THE fall of Waldemar Pawlak as Polish prime minister in February 1995, following an unrelenting series of attacks directed against him by his onetime patron, President Lech Wałęsa, furnishes a striking illustration of the conflict over executive power that has become familiar throughout East Central Europe since the fall of communism. Only slightly less dramatic were events in Slovakia: the March 1994 no-confidence vote forcing Vladimír Mečiar to step down as prime minister of Slovakia, his return following parliamentary elections, and his subsequent attempt to force President Michal Kováč from office. Mečiar's March demise came just days after the president had charged him with seeking to use proceeds from privatization for the benefit of

*An earlier version of this article was delivered at the Ninth International Conference of Europeanists, Chicago, March 31–April 2, 1994. The present version was completed in August 1995 and thus does not take account of the November 1995 Polish presidential election or the controversy that followed the kidnapping of the son of the Slovak president, Kováč.

[1] Translated in *FBIS-Eastern Europe*, February 28, 1994, pp. 14–15.

[2] Warsaw Radio Zet interview, February 25, 1994, trans. in *FBIS-Eastern Europe*, March 2, 1994, p. 23. Miller was responding not to the statement above but to Wałęsa's remark that he would soon begin the process of "file-checking and decommunization."

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his party, and it followed several months of growing, well-publicized hostility between the two.

Like Petre Roman in Romania, Filip Dimitrov in Bulgaria, and Jan Olszewski in Poland, Mečiar fell after the president identified himself with a broader public discontent toward the government and its policies. In the case of Pawlak, presidential pressure took advantage of already existing fissures within the governing coalition. Sharp conflicts also characterized the relationship between the Hungarian president, Arpád Göncz, and the prime minister, Jozsef Antall, until the latter's death in December 1993. Only in the Czech Republic (and in Czechoslovakia prior to the country's breakup) have the president, Václav Havel, and the prime minister, Václav Klaus, managed to avoid an open rift. But even they have publicly aired some policy disagreements, and their evident differences in temperament and ideological predilections have led journalists and other observers to speculate over tensions between them.

How can we explain the pervasiveness of presidential–prime ministerial conflict in all the East European states that had formerly been part of the Soviet bloc? While individual personalities and the particular constellation of issues in each country have helped shape the conflict in each case, I argue in this essay that it is more fundamental structural factors which account for the striking recurrence of such struggles. Some of these factors reflect the special circumstances of Eastern Europe in the postcommunist period, some are common to emerging democracies, and others reflect the particular characteristics of parliamentary democracy as a regime type. I also briefly explore a second issue: the implications of the conflict for the success or failure of democratic consolidation in the region.

The welcome revival of scholarly interest in the influence of political institutions on politics has to date left only a modest imprint on the comparative study of political executives.[3] One question, however, has proved an exception: the renewed debate over the relative virtues of presidential as opposed to parliamentary systems of government, par-

[3] In their seminal article, James G. March and Johan Olsen do not cite any studies of the executive per se (apart from references to "administrative capacity" and to "the state") in their list of examples of the growing scholarly interest in political institutions; see March and Olsen, "The New Institutionalism: Organizational Factors in Political Life," *American Political Science Review* 78 (September 1984), 734–35. See, however, Richard Rose and Ezra N. Suleiman, eds., *Presidents and Prime Ministers* (Washington, D.C.: American Enterprise Institute, 1980); G. W. Jones, ed., *West European Prime Ministers* (London: Frank Cass, 1991); Jean Blondel and Ferdinand Müller-Rommel, eds., *Cabinets in Western Europe* (New York: St. Martin's Press, 1988); Thomas A. Baylis, *Governing by Committee: Collegial Leadership in Advanced Societies* (Albany: State University of New York Press, 1989).

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ticularly with respect to the suitability of each for the building and consolidation of new, or newly restored, democracies.[4] The presidential/parliamentary dichotomy has in some cases proved too stark to offer much guidance to those engaged in the practical tasks of institution building. Thus, no Latin American country has yet adopted parliamentarism, despite the urgings of scholars, and no European state has adopted pure presidentialism. But the debate has recently been usefully expanded to include forms of executive arrangements containing elements of both presidential and parliamentary rule, sometimes termed "semipresidentialism,"[5] and "strong" forms of parliamentarism, sometimes called *Kanzlerdemokratie*.[6] The number of Western countries that fall unambiguously into the first category is small—France and Finland are the most frequently cited examples—but bringing them as well as variants of the parliamentary model into the discussion suggests the wide range of more subtly differentiated options that real-world "constitutional engineers" have available to them.

For students of the countries of the former Soviet bloc and the former Yugoslavia, the debate has been of special interest. Generally, the countries that once were part of the Soviet Union or Yugoslavia have chosen forms of semipresidentialism in which there is, in addition to the president, a prime minister nominally accountable to an elected parliament; but it is the president who is the dominant figure in both symbolic and policy terms. The model sometimes cited in these countries is that of Fifth Republic France, but in a number of instances the president's actual position seems more reminiscent of that of a communist-era first secretary. By contrast, the countries of Eastern Europe that once belonged to the Soviet bloc—Poland, Hungary, the Czech Republic and Slovakia, Romania, and Bulgaria—have each adopted variants of the parliamentary system, often borrowing from the German version of that regime type. While the Polish and Romanian discussions were also influenced by the French model (and the authors of

[4] See Arend Lijphart, ed., *Parliamentary versus Presidential Government* (Oxford: Oxford University Press, 1992); Juan Linz and Arturo Valenzuela, eds., *The Failure of Presidential Democracy* (Baltimore: Johns Hopkins University Press, 1994); Matthew Soberg Shugart and John M. Carey, *Presidents and Assemblies* (Cambridge: Cambridge University Press, 1992).

[5] See Giovanni Sartori, "Neither Presidentialism nor Parliamentarism," in Linz and Valenzuela (fn. 4), 106–18; he also uses the term "semi-parliamentarism." And see Shugart and Carey (fn. 4), 23–25 and passim, who distinguish between "premier-presidential" and "president-parliamentary" regimes.

[6] See Sartori (fn. 5), 109–10. *Kanzlerdemokratie*, a term originally used to refer to the German parliamentary system under Adenauer, does not to my mind accurately characterize the German system today. See Arend Lijphart, "Presidential and Majoritarian Democracy: Theoretical Observations," in Linz and Valenzuela (fn. 4), 94–95; Baylis (fn. 3), 72–79.

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the Polish "little Constitution" refer to their system as "presidential-parliamentary"), the parliamentary features of the Polish system appear to date to have dominated; the Romanian situation is less clear.[7] (The remaining East European member of the bloc, the German Democratic Republic, has been absorbed into the Federal Republic's parliamentary system; the east German state governments are also parliamentary in form.) There are, however, significant differences in the constitutional details in the six countries: how the presidents are chosen, what formal powers are accorded them, the circumstances under which prime ministers and cabinets can be forced from office, and so on.

What can be said in all of these cases is that the question of the actual distribution of executive power has by no means been settled. In the case of Eastern Europe, the formal constitutional framework has become the terrain on which different institutions and their incumbents, including presidents and prime ministers, struggle to define their influence. Examination of the six East European cases suggests two observations. First, we must be careful not to fall into the error that was often characteristic of the old institutionalism and on occasion afflicts the new institutionalism as well: assuming that the choice of specific institutions largely determines the actual distribution of political power. Second, the relevance of the parliamentarism/presidentialism debate to institution building in new democracies is diminished to the extent that it overlooks the importance of possible variations *within* either form in institutional arrangements and actual political outcomes.[8] It is with the struggle over both formal institutional rules and the de facto distribution of executive power in fledgling parliamentary democracies that this essay is primarily concerned.

The role of presidents in Western parliamentary systems, and in particular their relationship to their respective prime ministers, has largely

[7] As has often been noted, the power of the French president depends heavily on his supporters' controlling a parliamentary majority. Wałęsa has little parliamentary backing; Iliescu's party is the largest in the Romanian parliament, but the Vacaroiu government has had to rely on the support of small nationalist parties to remain on power. One expert on Romania, Vladimir Tismaneanu, earlier pronounced himself simply unable to determine whether the country has presidential or parliamentary rule. Cited in Woodrow Wilson Center East European Studies Meeting Report, September–October 1993, 3. Professor Tismaneanu has since informed me, however, that he now believes Romania has shifted decisively toward presidential dominance.

[8] Weaver and Rockman observe that "policymaking structures and processes in parliamentary systems can vary tremendously across countries and over time. Indeed, comparing parliamentary systems and the American separation-of-powers system is less a matter of comparing apples and oranges than of comparing apples with all other fruits." R. Kent Weaver and Bert A. Rockman, "Assessing the Effects of Institutions," in Weaver and Rockman, eds., *Do Institutions Matter? Government Capabilities in the United States and Abroad* (Washington, D.C.: Brookings Institution, 1993), 19.

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been neglected by the social science literature; the principal exception seems to be a 1970 study by the German political scientist Werner Kaltefleiter.[9] The reigning assumption is that the respective roles of the two executives are complementary and clearly defined and distinguished in practice as well as theory: the president undergirds legitimacy and represents state or national continuity, while the prime minister exercises policy leadership and takes responsibility for the day-to-day functions of government.[10] In countries like Germany and Italy, the president is typically a senior political figure who puts aside narrow partisanship to act as something of a national father figure and, if circumstances demand, an arbiter in times of political crisis. The role played by Italy's Luigi Scalfaro in the wake of that country's "Tangentopoli" scandals and the fall of the Berlusconi government is an example.[11] German and Italian presidents have at times enjoyed great prestige and popularity (for example, Richard von Weizsäcker, Sandro Pertini), but their modest efforts to expand their prerogatives have had little success. And although Austrian presidents enjoy somewhat greater formal powers and are elected directly, they too have been overshadowed by their prime ministers; the current incumbent, however, is seeking to challenge that pattern.[12] In all three countries, subtle tensions between the two executives are not uncommon, but they rarely escalate into open conflict. Such conflict appears to be more frequent in semipresidential systems, such as those of France and (between 1976 and 1982) Portugal.[13]

In all parliamentary and semipresidential systems, however, the existence of two separately chosen chief executives implies a situation of "dual legitimacy"—precisely the weakness critics often attribute to presidential systems[14]—and thus the potential for conflict over prerogatives. What differentiates the East European cases from the parlia-

[9] Kaltefleiter, *Die Funktion des Staatsoberhauptes in der parlamentarischen Demokratie* (Cologne: Westdeutscher Verlag, 1970), as cited in Lijphart (fn. 6), 104.

[10] The classic statement of this division of executive labor is Bagehot's distinction between the "dignified" and "efficient" parts of the English Constitution. See Walter Bagehot, *The English Constitution* (London: Oxford University Press, 1928), 4. The assumption of complementarity, however, breaks down if the two executives do not have a common understanding of the boundary between the two parts.

[11] See Hansjakob Stehle, "Nervenkrieg um die Macht," *Die Zeit*, January 13, 1994, p. 4. The scandals implicated at least two former prime ministers along with many other politicians who were charged with bribery and criminal ties.

[12] See Werner A. Perger, "Wer ist der Schönste im Land?" *Die Zeit*, December 17, 1993, p. 5.

[13] Shugart and Carey (fn. 4), 63–65.

[14] See Linz, "Presidential or Parliamentary Democracy: Does It Make a Difference?" in Linz and Valenzuela (fn. 4), 6–8.

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mentary systems of Western Europe is the fact that, in the former, as in all newly constituted democracies, the distribution of authority is necessarily ambiguous and fluid. Formal constitutional and statutory provisions provide a broad framework for the exercise of power, but there are no precedents and established conventions and understandings that define the boundaries between key institutions more precisely. Respect for the rule of law is not well developed in any case, part of the legacy of the communist period. Thus, leading political actors can be expected to try to define their own prerogatives broadly and in so doing are likely to collide with the expectations and ambitions of one another.

"One conundrum facing would-be reformers in former authoritarian states," writes Robert Putnam, "is whether rewriting the rules of the game will produce the intended effects—or any effects at all—in how it is actually played."[15] New rules and institutions, I suggest, do not instantly produce firm realities but rather create a loose structure that political actors seek to shape in the interest of their own power and policy objectives. At work is a "complex dialectic," as Linz and Valenzuela put it, between institutional rules and politicians' behavior.[16] Seen in this light, the struggles between presidents and prime ministers in East Central Europe are part of a broader competition for influence that also includes parliaments and their leaders, individual ministries, constitutional courts, and other bodies. There are as yet no political parties strong and disciplined enough to channel or rein in the competition. Rather, existing parties are typically small and fractious, and in most cases it is not at all clear whether they will survive over the longer term.[17] Interest-group structures and allegiances are similarly fluid. Both formal partisan coalitions and informal leadership alliances are correspondingly fragile and subject to sudden change.

The Conditions of Influence

In general, there is a discrepancy between the visibility and popularity of most East European presidents and their circumscribed constitutional powers. They have not been able to translate the former into a sustained expansion of their actual influence, although most have

[15] Putnam, *Making Democracy Work: Civic Traditions in Modern Italy* (Princeton: Princeton University Press, 1993), 17.

[16] "Preface," in Linz and Valenzuela (fn. 4), xii.

[17] See the stimulating observations on post-communist-era party development in Eastern Europe in George Schöpflin, *Politics in Eastern Europe* (Oxford: Blackwell Publishers, 1993), 243–48, 258–60, 267–69.

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sought to do so. The three presidents who are directly elected (those in Poland, Romania, and Bulgaria) can claim a broad, independent popular mandate that their prime ministers and the other three presidents, chosen by their countries' parliaments, cannot. The Western literature generally assumes, as have most participants in East European constitutional debates, that popular election significantly strengthens the president's position. This does not seem to be the case in such Western countries as Austria, Ireland, and Iceland, however.[18]

The significance of direct election in Eastern Europe is not yet proved. Direct election may have fired Lech Wałęsa's ambitions but does not appear in itself to have enhanced his influence; it may, however, have strengthened the constitutionally limited position of Romania's Iliescu. Both Bulgaria's Zhelev (directly elected) and Slovakia's Kováč (chosen by parliament) were able to rid themselves temporarily of prime ministers they disliked, but neither was subsequently able to keep a government more to his liking in office. Perhaps the clearest advantage a directly elected president enjoys is that he is less likely to be beholden for his initial selection and possible reselection to established political forces, including the prime minister's party, than a president chosen (as those of the Czech Republic, Slovakia, and Hungary are) by the parliament.

In a useful if somewhat mechanistic assessment of the formal constitutional powers of East Central European heads of state, James McGregor concludes that the Hungarian and Polish presidents have the highest weighted "power scores," followed closely by the Romanian and Bulgarian presidents, and then more distantly by the Czech and Slovak presidents.[19] (McGregor acknowledges the criticism that in practice the Polish and Romanian presidents appear to be stronger and the Hungarian president weaker than his ranking suggests.) All have the power customary in parliamentary systems to nominate the prime minister, who must, however, be able to command majority support in parliament. As elsewhere, this power can be significant if no party or prearranged coalition enjoys a clear majority. All can dissolve parliament and call new elections under certain limited circumstances. All can return legislation they disapprove of to parliament, but only in Poland is a two-thirds majority required to overcome presidential disapproval—a variation that gives the head of state a substantial boost in

[18] See Shugart and Carey (fn. 4), 71–72.

[19] James McGregor, "The Presidency in East Central Europe," *RFE/RL Research Report*, January 14, 1994, pp. 23–31; see also Christian Lucky, "A Comparative Chart of Presidential Powers in Eastern Europe," *East European Constitutional Review* 2 (Fall 1993–Winter 1994), 81–94.

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political leverage. All but the Czech and Slovak presidents have at least some emergency powers. The Polish, Hungarian, and Slovak presidents can introduce legislation, but cannot assure its passage, as Wałęsa for one has learned. Several presidents, including those of Poland, Hungary, and Bulgaria, are given special authority over foreign policy and defense (provisions going back in all three cases to each country's transition "pacts," concluded when it was expected that communists would retain the presidency for some time). The scope of their authority is not defined with any precision, however, and remains a matter of conflict.[20]

The greater popularity of presidents as compared with prime ministers undoubtedly owes something to the very limits placed on their governmental powers. They are not closely associated with unpopular economic measures or with the day-to-day partisan squabbling in parliament; in fact, their positions allow them to act as spokesmen for popular discontents. Wałęsa, for example, has claimed to speak for the "unrepresented" part of the Polish public, that is, those who voted for parties that failed to reach the threshold required for parliamentary representation.

The record of Presidents Wałęsa, Havel, Göncz, and Zhelev as prominent dissidents during the years of communist rule lends them a special legitimacy shared by few prime ministers (Poland's Mazowiecki is the clearest exception). Even Romania's Iliescu probably benefits from the demotions he suffered under Nicolae Ceauşescu after expressing disagreement with the imperious dictator. The international reputations of Wałęsa and Havel and their conscious efforts to cultivate them undoubtedly strengthen their hand domestically. Both have also benefited from nurturing the memory of their countries' popular interwar leaders, Marshal Piłsudski and Tomás Masaryk, and from identifying themselves with them.[21]

Most East European prime ministers, by contrast, led quiet and reasonably comfortable lives under communist rule, typically as scholars or researchers; nearly half were members of the ruling party itself.[22] Few

[20] On Poland, see Louisa Vinton, "Poland's 'Little Constitution' Clarifies Wałęsa's Powers," *RFE/RL Research Report*, September 4, 1992, p. 24. On Hungary, see Péter Paczolay, "The New Hungarian Constitutional State," in A. E. Dick Howard, ed., *Constitution Making in Eastern Europe* (Washington, D.C.: Woodrow Wilson Center Press, 1993), 39. On similar ambiguities and conflicts in Bulgaria, see Kjell Engelbrekt, "The Fall of Bulgaria's First Non-Communist Government," *RFE/RL Research Report*, November 13, 1992, p. 5.

[21] "Increasingly his personal role-model seemed to be Marshal Józef Piłsudski. . . . 'Really we should start by singing "We, the First Brigade,"' I heard Wałęsa tell the first meeting of the newly elected Solidarity-opposition parliamentarians, referring to the stirring marching song of Piłsudski's Legions in the First World War." Timothy Garton Ash, *The Magic Lantern* (New York: Random House, 1990), 34–35.

[22] See Thomas A. Baylis, "Plus Ça Change? Transformation and Continuity among East European Elites," *Communist and Post-Communist Studies* 24 (Fall 1994), 315–28.

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were well-known either within their countries or outside them prior to becoming prime minister. In a number of cases their political rise seems to have been almost fortuitous, the consequence of the unstable coalition politics characteristic of the region.[23]

Another factor favoring East European presidents is their relative security in office. All are chosen for five-year terms except the Romanian president, who serves for four years. Deposing them requires extraordinary circumstances and/or majorities. By contrast, prime ministers are subject to removal at any time because of the breakup of ruling coalitions and/or formal votes of no confidence. Since the fall of communism, the typical life span of East European prime ministers and their governments has been about a year; the three most notable exceptions have been Czechoslovakia's Čalfa, Hungary's Antall, and the Czech Republic's Klaus.[24] Hungary's prime minister is given extra security by a provision borrowed from the German Basic Law requiring a "constructive vote of no confidence"; that is, parliament must be able to replace a prime minister in order to vote him out of office.[25] To date, only Čalfa has managed to succeed himself, in contrast to the frequency with which prime ministers are returned to office in Western Europe. (Čalfa, it might be noted, was a former communist and a Slovak who became prime minister as part of the pact between the Czechoslovak opposition and the communists at the end of 1989; at the urging of Havel he was named to the post again after the June 1990 elections. While respected for his administrative expertise, he was overshadowed during his two and a half years in office by Havel and his finance minister, Klaus.)[26]

Prime ministers do enjoy the advantage of possessing the lion's share of constitutional powers in their respective countries and at least at the time of their election have the support (or acquiescence) of a parliamentary majority. The coalitions on which the majorities are based, however, have proved to be extraordinarily fragile; often even the prime minister's own party, much less its coalition partners, cannot be counted upon to support him. Splits within both governing and opposition parties and the appearance of new parties and political alliances have been

[23] In some instances prime ministers are little more than first among equals in what amounts to committee forms of governance. In such cases—the Mazowiecki government in Poland, for example—the "president vs. prime minister" rivalry is really a "president vs. government" one. See Baylis (fn. 3).

[24] High rates of government turnover seem to be typical of nearly all new democracies; see Samuel P. Huntington, *The Third Wave* (Norman: University of Oklahoma Press, 1991), 265–68.

[25] A similar provision, however, failed to save the Suchocka government in Poland.

[26] Judy Batt, "Czechoslovakia," in Stephen Whitefield, ed., *The New Institutional Architecture of Eastern Europe* (Basingstoke, England: Macmillan, 1993), 46–47.

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almost daily events in East European parliaments since the establishment of democratic rule.[27]

The roots of presidential–prime ministerial conflict are, then, apparent. Presidents find that their prestige and popularity vastly outweigh their formal powers and their actual political influence. Their sense of national responsibility and of their own distinctive legitimacy, as well as, in differing degrees, their ego involvement, leads them to seek ways of converting their assets of prestige into "real" power over policy. To this end, they often utilize the ambiguities in constitutional and legal provisions. Prime ministers, for their part, find themselves with considerable formal power but limited legitimacy. They frequently discover that the more they exercise their power in areas of controversy, the more their legitimacy tends to erode.[28] Incursions by presidents into what prime ministers view as their areas of responsibility seem particularly to threaten the success of their policies and with it their credibility, if not the actual maintenance of their parliamentary majorities. Accordingly, they fight back.

There are, however, exceptions to the "rule" of presidential–prime ministerial conflict. As already noted, the relationship between Havel and Klaus in the Czech Republic appears to be at least a partial exception. Moreover, Presidents Wałęsa and Iliescu appear to have had relatively amicable relationships with the successors to the prime ministers they helped force from office.[29] In what follows, we will also consider the special circumstances under which presidents and prime ministers have succeeded in coexisting relatively peacefully with one another.

Issues

There can be little doubt that most presidential–prime ministerial disputes are in essence struggles over power. Presidents seek to make full use of what they see as their legal prerogatives, which they interpret

[27] Slovakia's Mečiar, whose Movement for a Democratic Slovakia suffered critical defections prior to his fall in March 1994, has devised a novel method of impeding future departures: MDS candidates in the September 1994 elections were required to sign an agreement promising to pay the party 5 million Slovak crowns if they left it before the following elections. "Topics," *Transition*, March 15, 1995, p. 31.

[28] A somewhat similar comparison of the positions of president and prime minister has been suggested for France, with the important difference that the French president seems to have enjoyed greater "political resources" (as opposed to the prime minister's "administrative and institutional resources") from the outset, owing to his parliamentary majority. See Robert Elgie and Howard Machin, "France: The Limits to Prime-Ministerial Government in a Semi-presidential System," in Jones (fn. 3), 62–78.

[29] In Wałęsa's case, this assertion applies to Olszewski's successor, Hanna Suchocka, but not to Pawlak's successor, Jozef Oleksy.

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broadly and often seek to expand. Prime ministers resist what they see as presidential encroachment and contest ambiguous constitutional turf, often explicitly complaining that the president has exceeded his legal authority or at least violated what they see as the norms of an appropriate presidential role. Frictions based on differences in personality and leadership style often reinforce these conflicting interpretations of the extent of the president's authority.

Specific disputes have frequently concerned the appointment or removal of cabinet ministers and other high state officials, who come to be identified either as the "president's men" (rarely women) or those of the prime minister. Wałęsa, for example, has fought Polish governments over his insistence that the ministries of foreign affairs, defense, and internal affairs were "presidential" offices, even though the constitution requires only that the prime minister "consult" with the president before filling them. The president's refusal to approve the appointment of the postcommunist SLD's choice of finance minister seriously impeded economic policy-making in the first months after the party's 1993 election victory. Slovak president Kováč's rejection of Prime Minister Mečiar's appointee as privatization minister, following Kováč's reluctant acquiescence in two earlier dismissals of officials, deepened the alienation between the two executives.

Specific disputes have also revolved around substantive issues: control of the media, for example, the pace of economic reform, foreign policy questions, or decommunization. In most cases these disputes over policy and personnel do not reflect fundamental ideological differences. Frequently, presidents and the prime ministers with whom they do battle came originally from the same parties or movements. One exception to this principle was the case of Hungary, where in 1990 the victorious Hungarian Democratic Forum agreed to the election of a president from the opposition Alliance of Free Democrats in exchange for various concessions, including an agreement to reduce the number of laws requiring a two-thirds majority for modification.[30] To that extent, the disputes between Antall and Göncz were virtually preprogrammed. But disagreements that were no less bitter broke out between Lech Wałęsa and the leader of the (initially) pro-Wałęsa Center Alliance Party and former Solidarity lawyer Olszewski, the Bulgarian Union of Democratic Forces' Prime Minister Dimitrov and former UDF leader Zhelev, Ion Iliescu and Prime Minister Roman, both of the Ro-

[30] Bill Lomax, "Hungary," in Whitefield (fn. 26), 87. Lomax notes that the agreement was made by Antall and Göncz "over the heads" of the leadership of their parties.

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manian National Salvation Front, and President Kováč and Prime Minister Mečiar, both of the Movement for a Democratic Slovakia. The recent election of postcommunist prime ministers in countries whose presidents were prominent dissidents has led to conflict in Poland and Bulgaria but not Hungary. In the Czech Republic, although Havel and Klaus have significant ideological differences—Havel does not share Klaus's Friedmanite economic philosophy or the lust of some of Klaus's followers for punitive measures against former communists, while Klaus rejects Havel's commitment to strengthening "civil society"[31]—the two have generally kept their disagreements within bounds.

Rather than ideology, what seems to be critical is how presidents perceive their role. On winning office, presidents have given up any previous party affiliation (some, like Havel and Wałęsa, had never joined a party at all) and have quickly come to regard themselves as suprapartisan representatives of the interests of the nation and its people.[32] Taking advantage of the opportunities offered by their office and personal reputation, they seek to use the presidency as a bully pulpit from which to address the ills of the nation. Often, in so doing, they have found themselves moved to admonish the government, parliament, or various social groups that they believe are acting in divisive ways or otherwise damaging national interests. "Our public life now is portrayed by permanent political struggle," Michal Kováč reported in a "State of the Slovak Republic address" just prior to the parliament's vote removing Mečiar.

> Many point to the autocratic way of the prime minister's governing. Whoever voices a different view or a different standpoint is gradually disloyal, lacking solidarity, and, in the end, becomes a traitor. . . . I appeal to all of you, including the prime minister, to unite forces and take steps that will start a stage of political, national, and civic reconciliation.[33]

Presidents, in other words, have easily assumed the role of popular tribunes, as much because of the logic of the positions they occupy as because of their own instincts and political histories. Prime ministers, with some exceptions, have tended to see themselves as problem solvers

[31] See Jiri Pehe, "A Leader in Political Stability and Economic Growth," *Transition*, January 30, 1995, pp. 29–30.

[32] Western presidents have provided something of a model by seeking to identify themselves with popular hostility to what they see as the excessive influence of parties—France's de Gaulle and, more recently, Germany's von Weizsäcker and Austria's Klestil are examples.

[33] "Kovac Gives 'State of Republic' Speech," *FBIS-Eastern Europe*, March 10, 1994, pp. 6, 8.

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and/or as brokers within their own coalitions.[34] Unlike the presidents, most have backgrounds as lawyers or economists, or at least economic officials (see appendix). Like Poland's Mazowiecki or Suchocka, they have sometimes been accused of neglecting the need to sell their policies to a broader public.

Klaus, an odd mixture of pragmatist and arrogant ideologue, is a notable exception. He is the one East European prime minister who has been successful both in setting forth a determined course of policy and in undertaking a "permanent campaign" (including regular trips outside Prague and weekly radio talks and newspaper columns) to persuade the public of its correctness.[35] Klaus is also distinctive in his success at creating a strong, well-financed, ideologically homogeneous, and (to date) popular political party to back him, the Civic Democratic Party, which emerged from the split (engineered by Klaus) of the Velvet Revolution's Civic Forum.

Two areas of policy dispute deserve special attention here: control over the media and decommunization. The protracted battle between the Antall government and President Göncz over the leadership of Hungarian radio and television reflected the belief of the former that both the print media and, until it managed to force personnel changes, the state electronic media were unremittingly hostile to it. The president and his allies in the Alliance of Free Democrats were convinced, by contrast, that the Antall government wanted to turn the media into its obedient instruments and were thereby violating the procedural norms of democracy.[36] Only slightly less publicized controversies over media control have erupted in Slovakia and Poland. All parties recognize the importance of the media in their power struggles, especially against the background of state media control under communism and the need to set up new supervisory authorities over the public airwaves and to allocate broadcast space to private companies.

The sensitive questions concerning the legacy of the communist past and the treatment of former party officials and secret police informers

[34] "The relation between Václav Havel and Václav Klaus . . . recalls Walter Bagehot's classic commentary on the difference between the British monarch and the PM: the former is the object of public affect and reverence, while the latter is a cool technocrat, performing a multitude of operations that few ordinary citizens completely understand." Stephen Holmes, "A Forum on Presidential Powers," *East European Constitutional Review* 2–3 (Fall 1993–Winter 1994), 36.

[35] See Jane Perlez, "A Key Czech Learns to Speak Politics," *New York Times*, February 25, 1994, p. A4.

[36] See Judith Pataki, "Power Struggle over Broadcasting in Hungary," *RFE/RL Research Report*, March 12, 1993, pp. 16–20.

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have generally found East European presidents on the side of relative leniency and reconciliation.[37] Partly because of the conciliatory imperatives of their position, and in spite of their own dissident background, nearly all have come under attack for tolerating the continued presence of the nomenklatura in key positions, encouraging "recommunization," or even being agents or informers themselves. While the more reckless of these attacks often come from the nationalist right, many have been delivered by the prime minister's allies or even the prime minister himself. Thus Roman (himself the son of a prominent communist official) attacked Iliescu's supposed nostalgia for the communist past, the UDF charged that Zhelev (once a critical Marxist) and Berov were responsible for "creeping recommunization," and even Wałęsa was attacked by the Olszewski camp, which charged that his closest adviser was and remains a secret police agent.[38] Of course, prime ministers themselves are not all immune from similar attacks: Mečiar has long been rumored to have been a police agent,[39] and former communists now also lead governments in Poland, Hungary, Bulgaria, and Romania. The frequency of such assaults on presidents, however, seems to reflect resentment against their role as conciliators as well as an effort to undermine their popular credibility.[40]

Tactics

Given the limited constitutional powers of the presidents, those who wish to maintain or expand their influence must seek allies. Here, presidential assertiveness combined with tactical finesse is essential. The third key player in East Central European politics—the third component of the "Bermuda Triangle," as Wałęsa has termed it—is the parliament. Unlike most of their counterparts in Western Europe, East European parliaments have not become accustomed to docile subordi-

[37] For an informative comparative assessment of decommunization in Eastern Europe, see Helga A. Welsh, "Dealing with the Communist Past: German and East European Experiences after 1990," *Europe-Asia Studies* (forthcoming).

[38] See Louisa Vinton, "Walesa and the Collaboration Issue," *RFE/RL Research Report*, February 5, 1993, pp. 10–17.

[39] See Ray Taras, "Leaderships and Executives," in Stephen White, Judy Batt, and Paul G. Lewis, eds., *Developments in East European Politics* (Basingstoke, England: Macmillan, 1993), 176.

[40] Another factor, which has also been used to explain the electoral misfortunes of many former dissidents, may be the resentments of those elites and ordinary citizens—the great majority—who did not resist communist rule. Andrew Nagorski quotes the Czech dissident Václav Malý: "Many people had collaborated in some way. People don't like to see people who struggled against the communists. It's a covert pleasure to push them out of politics." Nagorski, *The Birth of Freedom* (New York: Simon and Schuster, 1993), 125.

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nation to the cabinet.[41] Other potential sources of support may be found in the constitutional court, various political parties and interest groups, and parts of the media. Within these institutions, the president needs "informal networks of political allies and associates."[42]

In some cases the volatility of political alliances and of partisan attachments has allowed presidents to exploit divisions within parliament to help bring down governments and replace them with more congenial alternatives. Thus, Bulgaria's President Zhelev was blamed—not unjustly, it appears—by the UDF for the collapse of the party's coalition with the predominantly Turkish Movement for Rights and Freedom (MRF); he then lent his support to the successor government headed by his former chief economic adviser Lyuben Berov.[43] And Slovakia's Kováč had called for Mečiar's resignation as early as December 1993 and proposed the formation of a broad coalition government; he took advantage of a revolt within Mečiar's Movement for a Democratic Slovakia (MDS) led by Foreign Minister Jozef Moravčik and Deputy Prime Minister Roman Kováč to hasten the prime minister's fall and help bring to office a new government led by the MDS dissidents and supported by the former Communist Party and the Christian Democrats. Even Wałęsa, who has more often battled with parliament than cooperated with it, seized upon the Sejm's disaffection with the Olszewski government's inept efforts at decommunization to force it from office.[44] Wałęsa's first choice for new prime minister, Waldemar Pawlak, was unable at that time to win approval for his government, however.

Wałęsa has been the most unabashed of the East European presidents in promoting the creation of a presidential system, but his efforts to persuade parliament to grant him the necessary powers have been largely unsuccessful. He was forced to withdraw his own draft of a "little Constitution" submitted to the Sejm after the October 1991 parliamentary elections, and the version finally adopted in late 1992 sought to maintain a balance between the president, the government, and the parliament. The president's office complained that overall it served to

[41] See, however, the diversity of Western cabinet-parliament relationships described in Michael Laver and Kenneth A. Shepsle, *Cabinet Ministers and Parliamentary Government* (Cambridge: Cambridge University Press, 1994). On East European parliaments, see Thomas F. Remington, ed., *Parliaments in Transition* (Boulder, Colo.: Westview Press, 1994).

[42] See Venelin Ganev, "Bulgaria II," in "Survey of Presidential Powers: Formal and Informal," *East European Constitutional Review* 2–3 (Fall 1993–Winter 1994), 64.

[43] Ibid., 62–64.

[44] The complicated dispute also involved the question of control over the Defense Ministry and the armed forces. See the account in Andrew A. Michta, "The Presidential-Parliamentary System," in Richard F. Starr, ed., *Transition to Democracy in Poland* (New York: St. Martin's Press, 1993), 62–69.

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perpetuate "sejmocracy."[45] After the 1993 elections, won by the post-communist SLD and its peasant allies, Wałęsa sent a populist proposal to the Sejm constitutional commission that would have allowed citizens to submit their own constitutional drafts; after the Sejm rejected it, Wałęsa withdrew his representative to the commission.[46] Similarly, Havel's proposals to the Czechoslovak parliament were rejected in January 1992; these would among other things have permitted him to call referenda and to dissolve parliament in case of a stalemate and then rule by decree prior to new elections.[47] After the breakup of the country, Havel sought to have the new Czech president elected directly and granted additional powers in domestic affairs. Again, he was largely unsuccessful.[48]

The fact that presidents are supposed to be "above parties" puts them at a strategic disadvantage in mobilizing concrete support for their positions. For that reason, several have been associated with efforts to create "presidential" parties. In Poland the Center Alliance emerged from the division within Solidarity between the forces supporting Wałęsa in the 1990 presidential campaign and those supporting the Mazowiecki government. But Wałęsa's policies following the election disappointed his erstwhile supporters, and by 1992 he and the alliance had become bitter enemies. During the 1993 parliamentary election campaign Wałęsa's supporters created the Nonparty Bloc to Support Reforms (BBWR), named to suggest a parallel with the bloc set up by followers of Marshal Piłsudski in 1927; the BBWR managed to win just sixteen seats in the Sejm.[49] Prior to the 1992 elections supporters of Havel sought to establish a new party in support of his policies, but neither it nor Jiří Dienstbier's liberal Civic Movement, perhaps ideologically closest to the president, were able to elect any members to parliament. Supporters of Romania's Iliescu formed a breakaway Democratic National Salvation Front after they were unable to wrest control of the original NSF

[45] See Vinton (fn. 20), 22; Michta (fn. 44), 74.

[46] See Wiktor Osiatynski, "Poland's Constitutional Ordeal," *East European Constitutional Review* 3 (Spring 1994), 29–38. After a "truce" was negotiated in April 1994, Wałęsa's representative returned to the commission. In June 1995 the Polish media reported that the commission had decided to reduce the number of votes needed to override a presidential veto to 50% plus one, but otherwise to retain many of the presidential powers granted by the "Little Constitution." *OMRI Daily Digest* (electronic version), June 19, 1995.

[47] Katarina Mathernova, "Czecho?Slovakia: Constitutional Developments," in Howard (fn. 20), 73–75.

[48] Jiri Pehe, "Czechoslovakia: Toward Dissolution," *RFE/RL Research Report*, January 1, 1993, p. 87; Berthold Kohler, "Der Freiheitsheld verliert an Glanz," *Frankfurter Allgemeine Zeitung*, January 16, 1993.

[49] Louisa Vinton, "Correcting Pilsudski: Walesa's Nonparty Bloc to Support Reform," *RFE/RL Research Report*, September 3, 1993, pp. 1–9.

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away from his rival, Petre Roman. It was as the candidate of the DNSF (since rechristened the Party of Social Democracy of Romania) that Iliescu won reelection as president in 1992.

Several presidents have recognized the importance of building their own staffs of advisers to act as a counterweight to the government apparatus generally subordinate to the prime minister. Unsurprisingly, presidential advisers often find themselves in conflict with government officials, and they are sometimes the objects of the sharp criticism that people may be reluctant to level against the president himself. "Since it is difficult to hit the president, you aim at his arms and legs," Wałęsa has noted.[50] (Wałęsa's own right-hand man, Mieczyslaw Wachowski, has been the object of particularly intense hostility.)[51] Presidents, for their part, can disavow incendiary statements or acts by their advisers if that should prove necessary to calm the waters.

One example of a bitter conflict over turf involving presidential advisers is the struggle between Wałęsa's National Security Bureau and the Defense Ministry under Olszewski (who had removed Wałęsa's appointee as defense minister).[52] Havel's staff, which numbered 630 in 1991, was the object of particularly sharp attacks; presidential departments and advisers were created for almost all areas of policy, a reflection of the president's ambition to expand his influence over domestic as well as foreign affairs.[53] In Romania, President Iliescu's staff was similarly organized in departments with responsibilities paralleling those of government ministries.[54] Bulgaria's Zhelev created a Political Consultative Council in 1990 that is said to have been "of vital importance in steering the country away from complete political breakdown."[55] In 1992 controversies surrounding presidential and prime ministerial advisers, and the underlying institutional rivalry in foreign affairs and military questions, contributed to the fall of the Dimitrov government.[56]

Generally, as the example of France's de Gaulle teaches us, crisis is the ally of ambitious presidents: it is when governments appear unable

[50] Nagorski (fn. 40), 107.

[51] "Mieczyslaw Wachowski: Eminence Gris," *Transition*, January 30, 1995, p. 45. Wałęsa dismissed Wachowski in August 1995 as presidential elections approached.

[52] Taras (fn. 39), 180.

[53] See Jan Obrman, "President Havel's Diminishing Influence," *RFE/RL Research Report*, March 13, 1992, p. 20.

[54] Jonathan Eyal, "Romania," in Whitefield (fn. 26), 132. "Most of those appointed to the staff," Eyal claims, "were old Securitate officers or communist party ideologues, and not one came from the opposition."

[55] Richard Crampton, "Bulgaria," in Whitefield (fn. 26), 20.

[56] Kjell Engelbrekt, "The Fall of Bulgaria's First Noncommunist Government," *RFE/RL Research Report*, November 13, 1992, p. 5.

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to cope with political stalemate or economic emergencies that presidents can most plausibly step in, invoking their responsibility as national arbiter. Presidents are also often in a favorable position to define what events constitute a crisis. I have already cited several instances in which an East European president has taken advantage of turmoil within a government coalition to intervene. A rather different case is presented by Romania's Iliescu in "accepting the resignation" of Prime Minister Roman after angry Jiu Valley miners descended on Bucharest in September 1991. Roman later asserted he had not intended to step down himself but wanted only to enlarge the government; he subsequently charged that Iliescu had in fact orchestrated the miners' assault in order to topple the government.[57]

Prime ministers have resorted to a variety of tactics in response to the political challenges posed by their presidents; the most effective may have been the use of parliamentary majorities and, on occasion, court decisions to frustrate the president's efforts to extend his formal powers. Klaus, for example, appears to have been instrumental in the parliament's decision to limit the president's powers in the Czech Republic's new constitution. Prime ministers and their allies have also criticized presidents for going beyond their "proper" symbolic role and even raised the specter (notably in Poland) of presidential dictatorship. They have removed presidential appointees and sympathizers from high government posts, tried to block the president's official travels, cut his budget, or simply sought to ignore him by neglecting to inform or consult with him even when constitutionally required to do so. The most dramatic and confrontational tactic—seeking to force the president from office—is likely to backfire. Mečiar's offer of the presidency to the postcommunist Slovak leader Peter Weiss in exchange for his party's support in deposing Kováč—a measure requiring a three-fifths vote of parliament—helped bring about the prime minister's own demise.[58] Mečiar's fall, and the earlier fall of Olszewski, along with the unwelcome fall 1993 election results following Wałęsa's dissolution of the Polish parliament, suggest the dangers for either side of overplaying its hand. Nevertheless, after returning to power Mečiar renewed his efforts to force Kováč from office,[59] and Wałęsa continued to use the threat of dissolution against the new parliament.

[57] Michael Shafir, "'War of the Roses' in Romania's National Salvation Front," *RFE/RL Research Report*, January 24, 1992, p. 16.

[58] "Mečiar und seine Partei gehen in die Opposition," *Süddeutsche Zeitung*, March 14, 1994, p. 8.

[59] See Sharon Fisher, "Prime Minister and President Grapple for Power," *Transition*, June 30, 1995, pp. 38–43.

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Exceptions

The only one of East Central Europe's current presidents who has not engaged in protracted conflict with at least one of his prime ministers is Václav Havel. As president of the Czechoslovak Federation, Havel's principal foe was the parliament, in particular its Slovak nationalist members, who exercised a de facto veto power in that body.[60] Havel's efforts to expand his own powers and to prevent the breakup of the federation failed, in part because the nationalists recognized that permitting the first would enhance Havel's ability to accomplish the second. Havel's hope of obtaining direct election and greater powers as Czech Republic president were also disappointed, owing to the opposition of Klaus's Civic Democratic Party.

Even before the country's "velvet divorce," the critical counterplayer to Havel in Czechoslovakia was not Prime Minister Čalfa but Klaus, then the finance minister. While Havel's economic views apparently differed from Klaus's, his lack of economic expertise and his overriding concern with saving the federation appear to have kept him from effectively resisting Klaus's reform program.[61] The sudden resignation of Klaus critic Richard Wagner as the president's economic adviser and his replacement by a Klaus ally in early 1991 appear to have marked a turning point with respect to this question.[62] While Havel did express discomfort over the harsh "lustration" (that is, decommunization) law supported by Klaus's party, Klaus himself does not seem to have been an enthusiastic advocate of the law.[63] As president of the Czech Republic, Havel's impassioned advocacy of firm Western measures in Bosnia, including support of the February 1994 NATO ultimatum, collided with Prime Minister Klaus's long-standing opposition to intervention there, but Klaus played down any differences between the two.[64]

[60] See David M. Olson, "The Sundered State: Federalism and Parliament in Czechoslovakia," in Remington (fn. 41), 102–3.

[61] An unsuccessful effort in 1990 to move Klaus out of the government by making him head of the state bank was rumored to have been "engineered by the president's office." Misha Glenny, *The Rebirth of History* (London: Penguin, 1993), 36.

[62] Erich Grolig, "Vaclav Klaus ist sich seiner Reformsache sicher," *Stuttgarter Zeitung*, May 11, 1991.

[63] See Jeri Laber, "Witch Hunt in Prague," *New York Review of Books*, April 23, 1992, pp. 5–8; Petr Janyska, "Imperfect but Right," *East European Reporter*, January–February 1992, pp. 59–60; Jan Kavan, "Imperfect and Wrong," *East European Reporter*, January–February 1992, p. 61; Nagorski (fn. 40), 76–91; Tina Rosenberg, *The Haunted Land* (New York: Random House, 1995), 67–121. The law bars various groups from high-ranking positions in government, state enterprises, and universities for five years; these include hundreds of thousands of former communist officials, members of the People's Militia, and secret police officials and those listed in their files as collaborators.

[64] See "Klaus on 'Dissection' of Differences with Havel," *Rude Pravo*, February 15, 1994, trans. in *FBIS-Eastern Europe*, February 17, 1994, pp. 4–5.

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The ability of Havel and Klaus to keep their differences from erupting into bitter conflict probably reflects some sober calculation on both sides and a sense of the complementarity of their respective roles. While one writer speaks perceptively of Klaus's "will to dominate" as a key to his character,[65] the prime minister seems to recognize that Havel's continuing domestic popularity and international prestige is a considerable asset for his regime. He also knows that the president has not been able seriously to impede his (Klaus's) policy agenda. Havel, a much less combative personality, has had to face the fact of Klaus's own popularity and the apparent success to date of his policies. He seems to have reluctantly acquiesced in his own political eclipse as Klaus's star has risen. Nevertheless, press reports of "tense relations" between the two suggest that Klaus does not find it easy to restrain his fabled arrogance even in dealing with the president, leading one to suspect that the last chapter of the Havel-Klaus relationship is yet to be written.[66]

President Wałęsa's relationships with Polish prime ministers have been more varied and more volatile. Prior to Wałęsa's election as president, a deep gulf opened up between the former union leader and his entourage and the Solidarity intellectuals around Prime Minister Mazowiecki, culminating in Wałęsa's decision to wage "war at the top" in a bitter and highly divisive election campaign. Wałęsa did not refrain from criticizing the succeeding government, led by Jan Krzystof Bialecki, but nevertheless generally backed it, even though its economic policies essentially perpetuated those the president had attacked during his campaign. Following the intense conflict with Prime Minister Olszewski (who had earlier been Wałęsa's first choice for prime minister before he turned to Bialecki), the president allied himself with Hanna Suchocka (also a second choice) "in spite of some early wavering."[67] After the 1993 elections, he demanded the right to name the new prime minister himself but subsequently accepted the victors' choice of Pawlak, leader of the Polish Peasant Party. Wałęsa quickly found himself at war with the postcommunist Democratic Left Alliance (SLD), the largest party in the new government coalition, but for the most part he initially refrained from attacking his onetime protégé Pawlak. Pawlak, for his part, took advantage of the hostility between the president and the SLD by playing one off against the other.[68] By the

[65] Jaroslav Veis, "King Klaus," *East European Reporter*, October 1992, p. 12.
[66] *Rude Pravo*, May 19, 1994, trans. in *FBIS-Eastern Europe*, May 23, 1994, p. 7.
[67] Louisa Vinton, "Walesa Applies Political Shock Therapy," *RFE/RL Research Report*, June 11, 1993, 9.
[68] See Anna Sabbat-Swidlicka, "Pawlak to Head Poland's 'Postcommunist' Government," *RFE/RL Research Report*, October 29, 1993, pp. 24–32; idem, "Pawlak Builds Up Peasant Power," *RFE/RL Research Report*, June 17, 1994, pp. 13–20.

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end of 1994, however, Wałęsa and Pawlak were engaged in what a Polish newspaper called a "tit-for-tat, you trick me, I trick you" struggle over such issues as tax policy and the replacement of the defense minister.[69] Wałęsa then threatened to dissolve parliament if Pawlak was not replaced, and in February the tension-ridden coalition acceded to his demand.[70]

One would have expected Presidents Zhelev, Iliescu, and Kováč to have been generally satisfied with Prime Ministers Berov, Vacaroiu, and Moravčik, respectively, since they were primarily responsible for their appointment. But while the Kováč-Moravčik relationship did not appear to erode during the latter's brief tenure in office, Iliescu reportedly soon became unhappy with the Vacaroiu government's resistance to economic reform, while Zhelev broke openly with his former adviser Berov in April 1994.[71] In doing so he charged that the Berov government had failed to carry out any of its principal objectives and had begun to "destabilize the country." As in France, presidential–prime ministerial relations seem to be most peaceful when the prime minister is complaisant. Like their French counterparts, however, Central European presidents appear to be quite willing to abandon even loyal prime ministers as scapegoats in times of trouble.

Toward Presidential Rule?

I noted earlier the revival of interest among political scientists in the last few years in the relative virtues of parliamentary and presidential forms of government, particularly in sustaining fragile democracies. The bulk of scholarly opinion, heavily influenced by Latin American cases, appears to be favorable to the parliamentary model; presidentialism, argue two recent critics, "systematically contributes to impasses and democratic breakdowns."[72] A dissenting view contends, however, that presidentialism often offers its citizens greater accountability and "identifiability" than does parliamentarism.[73] Among the public, the seductive belief persists that only a "strong hand" can assure the survival of fledgling democracies in fractious societies in the throes of sweeping

[69] Cited in Jane Perlez, "In Poland, It's Still Solidarity vs. the Communists," *New York Times*, January 8, 1995, p. 4.

[70] Jane Perlez, "Walesa's Foes Nominate New Premier," *New York Times*, February 8, 1995, p. A7; see also Louisa Vinton, "Velvet Restoration," *Transition*, January 30, 1995, pp. 42–44.

[71] Kjell Engelbrecht, "Bulgaria's Political Stalemate," *RFE/RL Research Report*, June 24, 1994, p. 23.

[72] Alfred Stepan and Cindy Skach, "Constitutional Frameworks and Democratic Consolidation: Parliamentarianism versus Presidentialism," *World Politics* 46 (October 1993), 19.

[73] See Shugart and Carey (fn. 4), 43–49.

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social and economic transformation.[74] East Central European publics have shown a low level of tolerance for the disarray of cabinets and the squabbling of parliaments. Presidents stand to be the natural beneficiaries of this discontent.

Ironically, however, the president who has called most openly for presidential rule and undertaken the most visible (if somewhat quixotic) efforts to bring it about has lost a great deal of his popularity in the process. Lech Wałęsa has at times tried to push his presidential powers to their constitutional limits and even beyond, for example, in threatening (in April 1994 and February 1995) to dissolve parliament in circumstances in which he did not have the legal authority to do so.[75] Early in 1995 support for his reelection dropped to only 9 percent of those surveyed; his popularity even fell below that of his communist predecessor, General Jaruzelski.[76] Wałęsa occasionally hints at using entirely extraconstitutional means (a "Yeltsin scenario") for achieving his goals, but does not appear to have the necessary support to pull it off.[77] The twists and turns of Wałęsa's policy agenda, his penchant for turning away from previous allies, and his vacillation over the role of the presidency—whether the president is to act as a "guardian of political balance" or as a goad for action, or is to intervene more directly in day-to-day politics—have all eroded his potential backing.[78] He has descended into the political fray too often to retain any credible claim to a "presidential" role as impartial arbiter; polls indicate that he is widely seen as a divisive and disruptive rather than a moderating or healing political force. It is also arguable that because of his working-class background (very different from that of, say, Havel or Göncz), as well as his unpredictable behavior in office, he does not fit the image often

[74] In a survey conducted in October–November 1991, 54.5% of Poles surveyed agreed that "a strong leader can do more for the country than all laws, debates, and consultations," but only 21.8% said that the president rather than the Sejm "should decide about the most important matters in Poland." (Another 21% answered the latter question "don't know.") Krzysztof Jasiewicz, "Polish Politics on the Eve of the 1993 Elections," *Communist and Post-Communist Studies* 26 (December 1993), 409.

[75] *RFE/RL News Briefs*, April 18–22, 1994, pp. 9–10; *OMRI Daily Digest* (electronic version), February 7, 1995.

[76] "Polls on Popularity of Politicians, Parties," Poznan WPROST, January 8, 1995, trans. in *FBIS-Eastern Europe*, January 6, 1995, p. 18. See also Jane Perlez, "From His High Pedestal, Walesa Has a Great Fall," *New York Times*, July 6, 1994, p. A5.

[77] Sabbat-Swidlicka (fn. 68, 1993), 24–25. Wałęsa's remark, it should be stressed, was made after Yeltsin's dissolution of the Russian parliament but before the latter's armed resistance and the storming of the parliament building. He has, however, also been quoted by a Polish weekly as saying: "When the time comes to introduce a dictatorship, the people will force me to accept this role and I shall not refuse. Most likely that is where we are heading." Perlez (fn. 76), A5.

[78] See the interesting comments of Louisa Vinton, "Walesa and the Elections," *Report on Eastern Europe*, November 1, 1991, pp. 10–11.

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preferred by Europeans, of a dignified, diplomatic, and somewhat paternalistic chief of state.[79]

Other presidents remain popular but have not been able to strengthen their legal or constitutional positions or, as one author has put it, institutionalize their charisma.[80] Even those who have enjoyed temporary triumphs over their former prime ministerial adversaries (for example, Zhelev, Iliescu, and Kováč) cannot be confident that the successor governments they supported will survive the next parliamentary crisis or new elections. Indeed, they cannot even be sure that these governments will remain faithful to their wishes. While presidential victories may serve as useful warnings to future prime ministers who might consider challenging them, they have not led to the establishment of solid precedents for presidential preeminence in critical policy decisions. Nor has the popularity of most of the present incumbents and public frustration with both governments and parliaments led anywhere to broadly based demands for a shift from a parliamentary to a presidential system.

This conclusion seems to stand in sharp contrast to the experience of some of the former Soviet and Yugoslav states. In Russia and Serbia, for example, struggles between presidents and prime ministers have been unequal contests, in which the presidents—nearly all former communists not notably inhibited by democratic niceties—have held the upper hand.[81] I have not examined any of these cases closely. But I suspect that the very severity of the crises in these states (recall my earlier contention that crises tend to favor the expansion of presidential power), and their less immediate concern with winning admission to the democratic "club" of the European Union, have permitted their presidents greater leeway to extend their authority.

What may be critical in the ultimate distribution of executive power in East Central Europe is the third side of the "Bermuda triangle"—

[79] "Many Poles seemed to expect that, once elected, Wałęsa would miraculously turn from a rough-edged electrician and union leader to a dignified statesman, with noble manners, speaking flawless Polish. This transformation of course could not take place, and the symbolic function of the Presidency seemed undermined by Wałęsa's slips of tongue and custom." Krzysztof Jasiewicz, "'My Name Is President': Lech Wałęsa and the Future of Presidentialism in Poland," in Ray Taras, ed., *The Presidency in Post-Communist States* (Cambridge: Cambridge University Press, forthcoming). After the completion of this article, Wałęsa's popular standing recovered somewhat, but he was nevertheless defeated in the November 1995 presidential elections by the postcommunist leader Aleksander Kwasniewski.

[80] Jasiewicz (fn. 79).

[81] On Russia, see two articles in *East European Constitutional Review* (Fall 1993–Winter 1994): Edward W. Walker, "Politics of Blame and Presidential Powers in Russia's New Constitution," 116–19; and Stephen Holmes, "Superpresidentialism and Its Problems," 123–26.

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the parliaments. More independent and jealous of their powers, albeit more deeply divided, than their docile West European counterparts, they appear as reluctant to cede broad powers to their presidents as they are to knuckle under to the discipline of their governments. We can expect presidential–prime ministerial struggles to continue so long as parliaments remain divided but powerful, and parties weak and poorly disciplined. The emergence of a strong presidential party or of stable governmental majorities could tip the balance, but the experience of Wałęsa and Havel suggests that such a party is not easy to create, while even initially large government majorities have proved fragile. The alternative would be some sort of authoritarian resolution, but the example of Yeltsin suggests that even that may not produce unquestioned presidential dominance.

Executive Leadership and Democratic Consolidation

Has presidential–prime ministerial conflict been damaging to the development and "consolidation" of democratic institutions in Eastern Europe at this time of their greatest fragility and vulnerability?[82] Jean Blondel has argued the contrary, that dual executive leadership can contribute to the stabilization of regimes by providing a "combination of authority and flexibility."[83] In Eastern Europe, a compelling case can be made that in several instances presidential intervention has provided a needed corrective to the low level of tolerance and/or the irresponsible populism displayed by some of the region's inexperienced governments, thereby impeding incipient authoritarian tendencies.

Thus, Göncz's defense of the independence of the Hungarian media, Wałęsa's derailing of the reckless decommunization campaign of the Olszewski government, and Kováč's push to remove Mečiar can all be viewed as positive contributions to the development of a democratic culture. On the other hand, Iliescu's coup against Roman and many of Wałęsa's other interventions must be regarded more negatively—as the "degradation of democracy," as one commentator has put it.[84] More-

[82] "Consolidation" is a term that is difficult to operationalize; too rigorous a set of requirements (e.g., the "two turnover test") is apt to disqualify even some long-established democratic systems, such as those of Japan and Italy. My own definition would emphasize in particular Huntington's "institutionalization," including the establishment of a relatively stable party system, and the broad acceptance of democratic values, e.g., tolerance of opposition, civil liberties, participation. See Samuel P. Huntington, *Political Order in Changing Societies* (New Haven: Yale University Press, 1968); Huntington (fn. 24), 208ff.; Giuseppe Di Palma, *To Craft Democracies* (Berkeley: University of California Press, 1990), 138ff.

[83] Jean Blondel, "Dual Leadership in the Contemporary World," in Lijphart (fn. 4), 170–72.

[84] "Whatever the case's merits, the demagogic means that Walesa used to achieve his ends became

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over, it could be argued that the suprapartisan posture assumed by presidents has helped inhibit the development of the stable party systems often regarded as essential for successful democracies. "Ambition counteracting ambition" in East Central Europe's dual executives, as in Madison's theory, has at times served to check the abuse of power, but at other times it has contributed to political deadlock and popular alienation.

Parliamentarism in itself—pace the arguments of writers like Linz and Stepan—cannot be assigned much credit for the survival to date of democratic institutions in Eastern Europe, if one judges by such measures as the generally negative popular assessments of both governments and parliaments, low voter turnout, and the outcome of the elections themselves. Presidents, arguably, have strengthened democratic legitimacy externally because of the prestige and respect most enjoy outside their countries' borders. This is a vital matter for states heavily dependent on Western economic ties and with previous histories of hostile relations with their neighbors. In most cases, the relative domestic popularity of presidents and their greater continuity in office appear also to have helped sustain the legitimacy of the new systems at home in the face of a general weariness with politics and considerable economic privation.

What of the future? Although the terms of most East European presidents still have some years to run, the current incumbents will ultimately be succeeded. The new presidents are not likely to resemble the present ones, who in most cases have come from dissident backgrounds; they may well come to office with a lower level of public prestige. But the very popularity of the current presidents, and their ability to exercise greater influence over events than their West European counterparts, suggests that their posts will be coveted, in most cases more than those of the region's embattled prime ministers.[85] If able public figures still in their prime seek and win the office, we can expect them to continue the efforts of their predecessors to strengthen its powers. To be sure, we can also expect the prime ministers and potential prime ministers of the day, insofar as they do not aspire to the position themselves, to maneuver to keep strong candidates (and thus

themselves a degradation of democracy. They loosed a squalor into Polish public life that persisted and proliferated." J. F. Brown, *Hopes and Shadows: Eastern Europe after Communism* (Durham, N.C.: Duke University Press, 1994), 71.

[85] It is noteworthy that Mečiar himself has expressed interest in the Slovak presidency, and Alexander Kwaśnieski, head of the dominant SLD in the current Polish coalition, chose to run for president rather than become prime minister.

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potentially formidable rivals) from being chosen, much as Chancellor Kohl did prior to the selection of a new German president in June 1994. Their success in doing so is likely to be mixed, depending in part on whether the president is chosen by the parliament or is directly elected. In either case, however, the precedents established by the first occupants of the office and their prime ministerial counterplayers will profoundly affect (and sometimes constrain) the ability of the next occupants to exercise influence. The potential extent of influence of executive roles in politics, as elsewhere, is never permanently fixed at a particular level. Sometimes, in fact, the backlash against a strong and ambitious incumbent serves significantly to weaken his successor. But there can be little doubt that the imprint on their offices left by the performance of East Central Europe's current group of presidents will be felt in their countries' political systems for decades to come.

Appendix

Table 1
Post-Communist-Era Presidents and Prime Ministers

Prime Ministers	*Year of Birth*	*In Office*	*Party*[a]	*A*[b]	*B*[c]	*Occupation*[d]
Bulgaria						
Lukanov, Andrei	1938	2/90–11/90	BSP	y	n	econ. official
Popov, Dimitar	1927	12/90–11/91	np	n	n	lawyer
Dimitrov, Filip	1955	11/91–12/92	UDF	n	n	lawyer
Berov, Lyuben	1925	12/92–1/95	np	n	n	economist
Videnov, Zhan	1961	1/95–	BSP	y	n	youth official
Czechoslovakia						
Čalfa, Marián	1946	12/89–7/92	np	y	n	lawyer
Strasky, Jan	1940	7/92–12/92	CDP	y	y	econ. official
Czech Republic						
Klaus, Václav	1941	7/92–	CDP	n	n	economist
Slovakia						
Mečiar, Vladimír	1942	7/92–3/94	MDS	y	n	lawyer
Moravčik, Jozef	1945	3/94–12/94	MDS	y	n	law professor
Mečiar, Vladimír		12/94–				
Hungary						
Antall, Jozsef	1932	4/90–12/93	HDF	n	n	historian
Boross, Péter	1928	12/93–6/94	HDF	n	n	manager
Horn, Gyula	1932	6/94–	HSP	y	n	state official
Poland						
Mazowiecki, Tadeusz	1927	8/89–12/90	DU	n	y	journalist
Bielecki, Jan K.	1951	1/91–12/91	LDC	n	y	economist
Olszewski, Jan	1930	12/91–7/92	CA	n	y	lawyer

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TABLE 1 (*cont.*)

Prime Ministers	*Year of Birth*	*In Office*	*Party*[a]	*A*[b]	*B*[c]	*Occupation*[d]
Poland						
Suchocka, Hanna	1946	7/92–9/93	DU	s	y	lawyer, professor
Pawlak, Waldemar	1959	10/93–2/95	PPP	s	n	farmer
Oleksy, Józef	1946	3/95–	DLA	y	n	party secretary
Romania						
Roman, Petre	1946	1/90–9/91	NSF	y	n	professor
Stolojan, Theodor	1943	10/91–10/92	np	y	n	economist
Vacaroiu, Nicolae	1943	11/92–	np	y	n	economist
Presidents[e]	*Year of Birth*	*In Office*	*Party*[a]	*A*[b]	*B*[c]	*Occupation*[d]
Bulgaria						
Zhelev, Zheliu (pe)	1935	7/90	UDF	y	y	philosopher
Czechoslovakia/Czech Republic						
Havel, Václav	1936	12/89–7/92 1/93–	np	n	y	playwright
Slovakia						
Kováč, Michal	1930	3/93–	MDS	y	n	econ. official
Hungary						
Göncz, Arpád	1922	5/90	ADF	n	y	translator, playwright
Poland						
Jaruzelski, Wojciech	1923	1985–12/90	PUWP	y	n	general
Wałęsa, Lech (pe)	1943	12/90–	np	n	y	electrician
Romania						
Iliescu, Ion (pe)	1930	5/90–	DNSF	y	n	ideologist

[a] Party affiliation (just prior to and/or while in office): BSP = Bulgarian Socialist Party; NP = non-party; UDF = Union of Democratic Forces; CDP = Civic Democratic Party; MDS = Movement for a Democratic Slovakia; HDF = Hungarian Democratic Forum; HSP = Hungarian Socialist Party; DU = Democratic Union; LDC = Liberal Democratic Congress; CA = Center Alliance; PPP = Polish Peasant Party; DLA = Democratic Left Alliance; NSF = National Salvation Front; AFD = Alliance of Free Democrats; PUWP = Polish United Workers' Party; DNSF = Democratic National Salvation Front.

[b] A = former member of Communist Party? y = yes; n = no; s = member of "satellite" party.

[c] B = former dissident? y = yes; n = no.

This category requires a somewhat subjective judgment as to what constitutes dissident activity. Thus I have not listed Mečiar or Kováč as dissidents; although both were expelled from the Communist Party after 1968, neither appears to have been active as a dissident prior to the Velvet Revolution.

[d] Occupation = principal occupation prior to 1989.

[e] pe = popularly elected.

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TAX COMPETITION IN WILHELMINE GERMANY AND ITS IMPLICATIONS FOR THE EUROPEAN UNION

By MARK HALLERBERG*

THE efforts by the European Union to integrate the markets of member states have made capital, goods, and to a lesser extent even labor more mobile. The much-anticipated elimination of border controls at the beginning of 1993 occurred largely as planned, with states having already abolished most restrictions on capital flows even earlier, on July 1, 1990. If member states do not coordinate their tax policies, however, this increased factor mobility could affect them adversely. In the short term a variety of tax rates could lessen or even eliminate the expected advantages of economic integration. Hans-Werner Sinn warns that unless "a barrier-free Europe" coordinates harmonization of taxes on goods and capital, it will "experience a reorganization of production on the basis of comparative tax advantage instead of comparative cost advantage," and the economic gains from a common market predicted by the Cecchini Report will not materialize.[1] Yet states will recognize the movement of factors and will adjust their tax rates accordingly, and over the long term competition for these resources will lead to a bidding down of rates and their eventual convergence even without state coordination. Pressure from abroad will mean that governments will lose control over the making of tax policy, and decreases in revenue, combined with intense competition for higher income indi-

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[1] Sinn, "The Case for European Harmonization," in Georg Winkler, ed., *Tax Harmonization and Financial Liberalization in Europe* (New York: St. Martin's Press, 1992), 5, 7. An overview of problems resulting from economic integration is found in Horst Siebert, "Perspektiven zur Vollendung des europäischen Binnenmarkts," *Kyklos* 42, no. 2 (1989).

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viduals, will force states to abandon certain social goals, such as redistribution, and may lead to the death of the welfare state.[2] Indeed, if Sven Steinmo's and Dwight Lee and Richard McKenzie's discussions of the decrease in marginal tax rates worldwide are to be believed, the feared negative consequences from tax competition within the European Union will simply accelerate a worldwide trend already taking place.[3]

How realistic are these predictions? A case that parallels the situation facing the European Union today in important ways is that of Wilhelmine Germany in the late nineteenth century. Before 1866 the individual German states had been separate countries that generally belonged to a common customs union, but after wars in 1866 and 1870–71 Prussia unified the states into one country. The new national government collapsed six currencies into one and also abolished previous restrictions on capital and labor mobility. At the same time, while the authority to impose and collect certain indirect taxes was transferred to the central government, each state still maintained the right to set its own tax and political system through World War I.

A comparison of the German states is also relevant because it offers a type of study that is not otherwise available for the European Union—a long-term analysis of the effects of factor mobility and a control for cultural factors.[4] The German states existed side by side for forty-five years, while the European Union ended most capital controls just four years ago. The German states also had more or less one culture, and because this variable is constant one can concentrate on the consequences of factor mobility.

The focus of this paper is on tax competition, since if it existed the only state preference that would matter is the one favoring the lowest tax rate. But what would the preferences of the various states be in the absence of tax competition? The answer depends on several factors, from the distribution of preferences in the general population to the in-

[2] Alberto Giovannini, "National Tax Systems versus the European Capital Market," *Economic Policy* 9 (October 1989).

[3] Steinmo, *Taxation and Democracy* (New Haven: Yale University Press, 1993); Lee and McKenzie, "The International Political Economy of Declining Tax Rates," *National Tax Journal* 17 (March 1989), 79–84.

[4] Several authors considered the parallels between the Zollverein and the creation of the European Community in the late 1950s and early 1960s, including Wolfram Fischer, "Der Deutsche Zollverein, die Europäische Wirtschaftsgemeinschaft und die Freihandelszone," *Europa-Archiv* 5 (1961); and the Introduction to W. O. Henderson, *The Zollverein* (London: Frank Cass, 1959). A more recent discussion can be found in Rolf H. Dumke, "Tariffs and Market Structure: The German *Zollverein* as a Model for Economic Integration," in W. R. Lee, ed., *German Industry and German Industrialisation* (London and New York: Routledge, 1991).

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stitutions used to filter them. Much of the literature on institutions today either considers systemic differences, such as the effects of parliamentary versus presidential systems, or concentrates on specific rules, such as how plurality and proportional representation influence the number of parties.[5]

These studies generally assume the existence of a democratic state. The German states, by contrast, brought into the empire a diversity of electoral institutions, from absolute monarchy to universal manhood suffrage, and it is these differences in the franchise that are used here to predict rough patterns of taxation. If governments had free rein to choose their own policies, the states should have levied a diversity of rates reflecting the political power of parties within the various state legislatures. In states where the franchise was restricted to wealthy landowners the tax system should have favored this group. Where the franchise was wider, however, the tax system should have been more progressive and favored the most populous economic voting group. Tax rates should not have harmonized.

To what extent did the German states maintain autonomy over their tax systems in the face of increasing economic integration? The first section examines the dynamics of tax competition and explains why it should have increased from 1873 to 1914. Had tax competition been the determining factor, tax rates on mobile factors would have converged. The absolute burden on mobile factors relative to immobile ones would also have decreased, because competition for the mobile factors would have pushed rates down and left the immobile factors with the burden. The second section evaluates these conclusions by comparing the taxes used and their rates in 1873 and 1914. Tax rates did converge for mobile capital and labor, but the change in burden was not in the expected direction. Instead, rates on capital and labor increased while rates on immobile land stayed the same or decreased. State competition for capital explains why rates converged, but the "defection" level of taxation increased during the period because of industrialization and because of increased transfers to the central government. The largest state, Prussia, set an example of higher tax rates on mobile factors that the other states followed. Differences in the extent of the franchise explain the pattern of taxation for the immobile factor of land: land taxes decreased in states with restricted franchises but stayed the same in places with more open political systems. The final

[5] Examples include Arend Lijphart, ed., *Presidential vs. Parliamentary Systems* (Oxford: Oxford University Press, 1992); and Rein Taagepara and Matthew Soberg Schugart, *Seats and Votes* (New Haven: Yale University Press, 1989).

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section discusses the results and their general relevance to the European Union.

THEORY

Within the European Union economic integration should affect most directly taxes on goods and taxes on capital. Since in Wilhelmine Germany the national government levied most excise taxes, the most important taxes to consider are those levied on capital.

The following discussion of tax competition is based on Charles Tiebout's classic article and the literature that has appeared since its publication.[6] Relative tax rates affect where investors place their capital when states assess income earned in a given territory equally, regardless of the nationality of the owner.[7] The important figure to the investor is return net of all taxes. For an illustration of the dynamics of capital movement and their effect on tax policy, consider a world with only two states. If capital is fully mobile, the states will begin a period in equilibrium where after-tax returns are the same everywhere. If State A cuts its tax rate, after-tax returns to investment will increase in that state, and capital will then flow into State A from State B because it offers the higher rate of return. This process will stop, however, before State B has lost all of its capital. This occurs because the flow of capital into State A increases the supply of capital in that state and depresses the rate of return, while simultaneously State B experiences a capital loss, and this decrease in supply of capital increases the return to capital. Capital will stop moving from State A to State B when after-tax returns in the states are again equal.

When will a state decide to cut its tax rate? Consider again the case

[6] Tiebout, "A Pure Theory of Local Expenditures," *Journal of Political Economy* 64 (October 1956), 416–24. A more recent treatment is Jacob A. Frenkel, Assaf Razin, and Efraim Sadka, *International Taxation in an Integrated World* (Cambridge: MIT Press, 1991). For an introductory summary of the issues facing the European Union, see Commission of the European Communities, *Report of the Committee of Independent Experts on Company Taxation* (Luxembourg: Office for Official Publications of the European Communities, 1992).

[7] This method is known as the *source principle*. Most industrialized states assess capital according to the *residence principle*, which taxes all income earned by persons residing in a given state, regardless of where the income is earned. States prefer this latter method because it should allow them to maintain different marginal tax rates; citizens pay the same tax rate regardless of where they invest. In order for the *residence principle* to operate in this manner, however, the state must have complete information on an individual's foreign holdings. If it is possible to hide income earned in certain states, then tax rates do affect investment decisions. A good summary is found in George Kopits, "Overview," in Kopits, ed., *Tax Rate Harmonization in the European Community*, International Monetary Fund Occasional Paper no. 94 (July 1992), 1–21. For a more technical discussion, see Frenkel, Razin, and Sadka (fn. 6), 21–42.

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of capital taxes. A state usually wants to attract capital for two reasons. First, it hopes to reap the economic benefits that capital provides; increased investment, for instance, spurs economic growth and provides jobs. Second, states hope to receive additional revenue in the form of taxes on capital.[8] A government will calculate whether an upward or downward change in the tax rate will affect the distribution of capital across states in its favor. If a state initiates a tax cut, the others then have two options: let the capital leave and accept the loss in tax revenue or lower their tax rates as well. If the threat that capital will leave is credible and the potential loss in revenue is large, the others will be forced to lower their rates as well. The result is that all states receive less revenue but that the distribution of capital remains the same.

In game-theoretic terms this situation is a standard Prisoner's Dilemma. To return to the two-country example, if both states cooperate with each other and maintain high tax rates, each benefits from a medium amount of revenue and a medium level of capital. If State A defects and State B cooperates, however, State A receives a transfer of capital at the expense of State B. State B also loses revenue from the lost capital, while State A likely gains revenue. If both states defect, they each receive lower revenues, but neither state suffers a capital loss. The dominant strategy of both states is therefore to defect, and both states pursue beggar-thy-neighbor policies and collect lower tax revenues as a result.[9] (See Figure 1.)

It should be emphasized that this discussion is relevant only when a factor is mobile, since competition for immobile factors is not possible. Yet a change in the relative mobility of one factor will affect the taxation on the other factors. When one becomes more mobile, the tax burden on the immobile factors will increase; that is, because factors like land cannot leave the state, they must bear whatever burdens are placed upon them. States will therefore increase the taxes on immobile factors to replace the lost revenue from those that are more mobile.[10]

[8] Margaret Levi assumes only that states maximize their revenue. The likelihood that states also want to attract the economic benefits from a given factor is not incompatible with the revenue-maximizing state. In both cases the government hopes to attract the movement of a given factor into its jurisdiction. Levi, *Of Rule and Revenue* (Berkeley: University of California Press, 1988).

[9] Giovannini (fn. 2), 368, also makes this point.

[10] Hans-Werner Sinn compares the situation facing the European Union to a perverse insurance market. "A Europe with competing tax systems and unrestricted migration would be like an insurance market where the customers can select their company and pay the premium after they know whether or not a loss has occurred." Sinn, "Tax Harmonization and Tax Competition in Europe," *European Economic Review* 34 (1990), 502.

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	Maintain Tax Rate	**Cut Tax Rate**
Maintain Tax Rate	(Medium K, T), (Medium K, T)	(Low K, T), (High K, T)
Cut Tax Rate	(High K, T), (Low K, T)	(Medium K, Low T), (Medium K, Low T)

FIGURE 1
PRISONER'S DILEMMA FACING TWO STATES ON TAX POLICY WITH MOBILE CAPITAL[a]

[a] K=Capital, T=Tax.

Did capital and labor in fact become more mobile within the empire after German unification, and if so did tax competition increase?

INCREASED FACTOR MOBILITY

Several changes in Germany made it easier for capital and labor to move from state to state. The creation of a common currency and a central bank to regulate it eliminated transaction costs arising from uncertainty about currency fluctuations. Changes in the regulation of banks allowed them to proliferate and provide capital more easily, while industrialization increased demand for capital and increased the importance of capital to the economy. Labor also became more mobile with the end of regulations governing its movement and the creation of a more integrated labor market.

Even before political unification, the Zollverein states had already established some elements of monetary unification with a common system for coins. Full monetary unification among the German states was still incomplete before the empire's establishment, however, because it excluded most paper money and because it was valid only in the Zollverein states.[11] In 1866 there were no fewer than 59 note-issuing banks, and in 1873 there were still 140 different denominations of paper currency.[12] In addition, there were six currencies in circulation

[11] Mecklenburg-Strelitz, Mecklenburg-Schwerin, and the three Hanseatic cities of Lübeck, Hamburg, and Bremen were not members of the Zollverein, while Luxembourg, which did not join the Reich, did participate in the customs union.

[12] Carl-Ludwig Holtfrerich, "The Monetary Unification Process in Nineteenth-Century Germany: Relevance and Lessons for Europe Today," in Marcello De Cecco and Alberto Giovannini, eds., *A*

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within the newly formed Reich in 1871, and this system meant that "payments in Germany were still quite complicated, the transaction costs high."[13]

Several moves toward a common currency reduced transaction costs and made capital more mobile. The First Coinage Act, passed in December 1871, sanctioned the creation of certain gold Reich coins and prohibited the states from minting new silver coins, although silver coins were still kept in circulation. The Second Coinage Act, passed in July 1873, mandated that all state coins except the silver taler were to lose their legal tender status, and it also provided for the minting of smaller silver Reich coins. The most important provision, however, concerned paper money—the act stipulated that as of January 1, 1876, only notes denominated in marks would still be valid, and the lowest denomination accepted would be the hundred-mark note. The restriction on the size of bills was intended to put pressure on banks that had thrived on issuing small notes which were rarely converted into metal. The states were also required to withdraw their paper money from circulation by the beginning of 1876.

The conversion of the Prussian Bank into the Reichsbank in January 1876 created essentially one authority to regulate the common currency. This change reduced the substantial information costs and uncertainty that investors faced when dealing with different currency-issuing banks across states. After the creation of the Reichsbank, thirteen of thirty-three note-issuing banks gave up their privileges immediately, and by 1906 the only remaining banks besides the Reichsbank were those of the large states of Bavaria, Saxony, Württemberg, and Baden. In effect, the creation of the Reichsbank gave Germany one monetary authority: "Since January 1, 1876, the German empire also had a note-issuing bank, that, if not the absolute note-issuing monopoly, also possessed overwhelmingly such a position, that one could speak of the bank as the central note-issuing bank."[14]

With industrialization state economies needed to attract more capital. In the period 1870–74, 38 percent of the net domestic product came from agriculture, while only 30 percent originated in industry. By

European Central Bank? Perspectives on Monetary Unification after Ten Years of the EMS (Cambridge: Cambridge University Press, 1989), 226.

[13] Knut Borchardt, "Währung und Wirtschaft," in Deutsche Bundesbank, *Währung und Wirtschaft in Deutschland, 1876–1975* (Currency and economy in Germany, 1876–1975) (Frankfurt am Main: Fritz Knapp, 1976), 3–4.

[14] Ibid., 20.

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1910–13 the proportions had reversed: agriculture accounted for only 23 percent of net inland product, while industry produced 41 percent.[15] Most importantly for the purposes of this paper, industrialization included the expansion of the form of financing most conducive to outside investing, the joint stock company. In 1871 total paid joint-stock capital was 971 million marks; by 1913 this amount had grown to 11.424 billion, or almost twelve times as much.[16]

Labor mobility also increased because of the creation of the German empire. In the nineteenth century most German states had laws that restricted one's occupation and even one's place of residence. While Prussia had repealed most restrictions already in 1807 and others began their repeal after the aborted 1848–49 revolutions, only in 1869 did the North German Confederation's new *Gewerbeordnung* give *Freizügigkeit*, or geographical mobility, to all Germans, which "accelerated the dynamics of industrialization by reducing the barriers for factor mobility."[17] The rapid expansion of railroads during this period made it easier for people to relocate to other areas of Germany.[18] A final factor that facilitated labor mobility was simply a common language and a relatively common culture. Census statistics indicate that many people took advantage of these conditions to move from one region to another within Wilhelmine Germany, especially from rural areas to the large cities. In many cities fewer than half of the residents were born there, and by the beginning of World War I one-fifth of Germany's population lived in cities of more than one hundred thousand persons, an increase from just one out of twenty in 1871.[19]

[15] Agriculture under this definition includes forestry and fishery, while industry also covers handicrafts. Other sectors that Hoffmann considers are mining, transportation, trade, household services, other services including the military, and nonagricultural residences, each of which accounted for less than 10% of net national product in 1910–13. An interesting finding is that spending on the military dropped from 10.4% in 1875–79 (i.e., four years after the end of war with France) to 9.0% in 1910–13. It appears that military spending did not keep up with economic growth. Walther Hoffmann, *Das Wachstum der deutschen Wirtschaft seit der Mitte des 19. Jahrhunderts* (The growth of the German economy since the middle of the nineteenth century) (Berlin: Springer-Verlag, 1965), 33.

[16] Ibid., 772–74.

[17] Quote in Hubert Kiesewetter, "Economic Preconditions for Germany's Nation-Building in the Nineteenth Century," in Hagen Schulze, ed., *Nation-Building in Central Europe* (Lamington Spa: Berg, 1987), 89. See also Richard J. Bazillion, *Modernizing Germany: Karl Biedermann's Career in the Kingdom of Saxony, 1935–1901* (New York: Peter Lang, 1990), 362.

[18] In 1871 the railroads had 5.0 billion kilometers of personal transportation; in 1913 this figure had increased more than eightfold, to 41.4 billion. Hoffmann (fn. 15), 399–400.

[19] In 1907, for example, just 40.5% of the two million residents of the capital city were native Berliners. The flight out of the countryside was just as dramatic; in the same year roughly one out of five born in the East Prussian provinces had moved on. Hoffmann (fn. 15), 180; Gerd Hohorst, Jürgen Kocka, and Gerhard A. Ritter, *Sozialgeschichtliches Arbeitsbuch: Materielen zur Statistik des Kaiserreichs, 1870–1914* (Social history workbook: Materials for statistics of the Kaiserreich period, 1870–1914) (Munich: Verlag C. H. Beck, 1975), 40, 19.

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Comparison of Rates and Tax Systems

Introduction

This section will compare the state tax rates at the beginning of the empire in 1873 with the state's last peacetime budget in 1914.[20] According to the model outlined above, the increased mobility of capital and labor should have changed the tax equilibrium present at the time of German unification. Taxes on capital and mobile labor should have harmonized downward to the lowest common denominator as states tried to keep their mobile factors from fleeing. At the same time taxes on immobile factors should have increased relative to mobile ones, and there is no reason to believe that they should have harmonized.

In the absence of tax competition the choice of which taxes to use and what rates to levy would rest with the governments of the individual states. The composition of statehouses varied widely according to differences in the extension of the franchise, and if these differences translated into policy there should have been a diversity of tax rates levied in both 1873 and 1914. The political openness of states varied from virtual one-man rule in Mecklenburg-Strelitz and Mecklenburg-Schwerin to universal male suffrage in Baden. By 1914 most of the states continued to rely on fairly restrictive political systems, but there were several notable exceptions. The larger southern states of Baden, Württemberg, Bavaria, and Hesse had competitive and open elections. In Baden from 1909 to 1911 the Liberals and Social Democrats formed a grand coalition and participated in the writing of the state budget, which was impossible in more restrictive Prussia, where the electoral system guaranteed the domination of the Conservative Party in the legislature. Two smaller states, Schwarzburg-Rudolstadt and Saxon-Weimar, also had open political systems. Thus, if the increased mobility of capital and labor did not constrain governments, tax rates should not have converged. The rates should have favored argiculture in more closed systems that favored large agricultural landowners and favored capital and perhaps labor in states with open franchises and where industrialization had created large urban constituencies.[21] (See the appendix for a comparison of the state electoral systems in 1914.)

It is also important to define the data set. In principle it includes

[20] The year 1873 is the first for which state tax systems reflect changes from the time of the unification of Germany, such as the transfer of tariffs to the national government, and is used as the initial comparison date instead of 1871.

[21] Political institutions filter preferences that already exist in the population; if a given state is overwhelmingly rural, it will favor agriculture even if it has an open political system.

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every German state, but unfortunately five of the twenty-six states must be excluded. The three Hanseatic cities of Bremen, Hamburg, and Lübeck are left out because fiscally they were simultaneously cities and states, and there is no way to separate the state component of their finances from the local component. Each had one budget, which included both expenditures that states usually made, such as matricular contributions, and expenditures that cities usually made, for such items as schools and roads. Alsace-Lorraine, territory that the empire gained from France in 1871, is also omitted because it was never a completely independent state. Through 1911 it was not considered a *Bundesstaat* like the other states but rather was a *Reichsland*. The latter status meant that the national government had direct responsibility for its governance; even after the Reichstag introduced universal manhood suffrage in 1911 the national government remained the de facto ruler. Mecklenburg-Schwerin and Mecklenburg-Strelitz are included but treated as only one state, which will be referred to simply as "Mecklenburg." They closely coordinated their tax reforms and as a consequence had essentially identical tax systems. Finally, although Saxony-Coburg and Saxony-Gotha were formally fused into one state, they continued to maintain fiscal independence from each other; consequently, this study will treat them separately. After the subtractions and the one addition there are twenty-two states used in the following comparisons.

Rates in 1873

Immediately after unification the states restructured their tax systems, but the net changes were not dramatic. Although the states could no longer collect customs and excise taxes, which they transferred to the Reich, they also no longer had military expenditures, one of the largest budget items, which now fell to the Reich. With unification, therefore, the transfer of most indirect taxes to the empire had "only an accounting relevance."[22] States more or less maintained their varied preunification systems. They taxed land, capital, and income at different rates and in general relied heavily on land taxes. Taxes on capital were low, and in many cases the state did not address capital at all.

The most difficult tax to compare is the land tax (*Grundsteuer*). States did not use uniform methods to assess the tax, and in some cases did not levy the same rate even throughout their own territory. Bavarian assessors tried to determine the gross output of a piece of land,

[22] Georg Schanz, "Der Reichshaushalt und das Finanzwesen der Einzelstaaten," *Finanzarchiv* 13, no. 1 (1896), 89 fn. 3.

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while Württemberg officials cared only about net figures. Baden did not try to compute output at all and instead based its tax on resale value. Many smaller states, such as Saxony-Weimar, relied on tax farming; they told local officials that they needed a certain amount of money from their district and it was up to the officials to decide whom and how much to tax. A uniform state tax rate therefore did not exist, and these states cannot be compared reliably with the others.

Nonetheless, some trends are evident. There was clearly more variation among the smaller states than among the larger ones. The most comparable states are those that used net average proceeds in their assessments, and the smaller states varied widely, from 3.8 percent in Reuß of the Older Line to 9 percent in Oldenburg. The three larger states were more stable with a flat tax of either 4 or 5 percent. Although Bavaria and Baden used different methods of assessment, their taxes are also roughly comparable to those of the other three states.[23] (See Table 1.)

States also used a diversity of personal taxes on income. Three states relied exclusively on a class tax, while seven states, including Prussia, administered the so-called classified income tax for higher incomes, which was a crude precursor to the income tax. In Bavaria, Brunswick, and Lippe-Detmold a partial income tax rounded out the system and was meant to address all other forms of income not covered by the other direct taxes. It is important to recognize that none of these taxes directly addressed capital income. Tax assessors usually used external indicators to determine one's tax bracket, and even under the classified income tax, assessments were generally rough. Only Hesse and Saxony after 1874 used a true income tax, which addressed all income regardless of its source, including income from capital.[24]

Despite the different ways in which states tried to address personal income, it is clear that the most mobile form of labor, high-income earners, paid different rates in different states. Mecklenburg-Schwerin

[23] A 1% tax on sales value would represent a higher burden than a 1% tax on gross proceeds, because the land value always exceeded a given year's production; a 1% tax on gross proceeds would also be more onerous than a 1% tax on net proceeds, since a person paying a net tax could deduct input costs that a person paying a gross proceeds tax could not. It is therefore no surprise that Prussia's 4% tax on nex proceeds is higher than Bavaria's 1.67% tax on gross proceeds and Baden's .44% tax on the land's resale value.

[24] Ulrike Metzger and Joe Weingarten, *Einkommensteuer und Einkommensteuerverwaltung in Deutschland* (Income tax and income tax administration in Germany) (Opladen: Westdeutscher Verlag, 1989), 48, 314. Although the tax became law in 1874, these rates were not actually levied in Saxony until 1878. The Prussian rates are available in Joseph A. Hill, *Quarterly Journal of Economics* 6, reprinted in Charles J. Bullock, *Selected Readings in Public Finance* (Boston: Ginn and Company, 1906), 257.

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TABLE 1
STATES WITH NET PROCEEDS TAX
(1873)

Large States	*Tax Rate (%)*
Prussia	4
Saxony	4[a]
Württemberg	5
Small States	*Tax Rate (%)*
Oldenburg	9
Schwarzburg-Rudolstadt	8
Schwarzburg-Sondershausen	6
Reuß Older Line	3.8
Schaumburg-Lippe	5
Average for all states	5.6
Standard deviation	1.95

[a]The rate for Saxony is the one set in the 1874 tax reform. In 1873 the rate was still 9 percent.

and Mecklenburg-Strelitz had no personal tax at all, while Saxony-Gotha and Württemberg each maintained the highest tax at 4 percent. This variation indicates that tax competition did not force a convergence of the marginal rates among the states under the Zollverein.

The amount of tax one paid did depend on where one lived, however, and this statement was as true in Germany as it was in the world generally. Indeed, in a comparison with other European states, it appears that there was more diversity within Germany than outside of it. The most industrialized country at the time, England, levied an income tax of just 1.25 percent, while France and Russia did not use any personal taxes at all. Austria-Hungary maintained a top marginal rate of 10 percent, but the country was still paying for war debt incurred during its losing struggle with Prussia in 1866. If one were to consider Austria an exceptional case and therefore leave it out of the sample, the top marginal tax rate would be in England, which at 1.25 was not much higher than zero.[25]

Businesses were also taxed at different rates across states. Indeed, half of the states did not tax businesses at all. (See the appendix for data on

[25] The figures are available in the appendix.

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each state.) Most of the states that did tax businesses used a general business tax that divided them into different classes. Because local business associations often determined the rates that businesses ultimately paid, a direct comparison of taxes in 1873 is impractical. This problem is not intractable, however; it is likely that businesses also had difficulty estimating what their tax burden would be if they were to relocate to another state. Indeed, if relocation meant joining a new business organization and losing influence in the previous one, there was a clear disincentive to relocate. Again the only states where the tax rate was clear were Hesse and Saxony, which levied a general income tax upon businesses. Bavaria's capital rent tax also covered businesses, but its use of external criteria to place businesses in certain classes made it similar to the business taxes levied elsewhere.

In general, states developed these tax systems before industrialization took off, and the economic structure left its imprint. While there were examples of personal taxes, most collections came from taxes on the dominant sector of the economy—agriculture.[26] There was significant variation among the states both in the types of taxes they used and in the rates they levied, and capital in particular was not treated equally across states.

Tax Rate Convergence, 1914

> Many supporters of an increase in the tax rate for the highest incomes would like to address not so much the large landowners as much as really so-called "mobile capital." But if also in this direction an attempt should be made, it will miscarry! In our time of international trade, the telephone and the telegram the owners of "mobile capital" are in no way bound to a specific residence. [If] the demands of the state on their performance become too large, then the danger is near that they will brush the Prussian dust from their feet and leave. They do not need to leave the Reich, but only settle down in another German state whose tax rates are not so burdensome, and the Prussian Fiskus would then be left out in the cold.[27]

The following discussion of the tax rates in 1914 indicates that tax competition forced a harmonization of tax rates on mobile labor and capital. Contrary to what one would expect under the tax competition model, however, personal tax rates did not converge downward but rather moved upward. Another unexpected result is that the tax burden did not shift to the principal immobile factor, land. To the contrary, in

[26] For a more detailed discussion of the taxes used and the distribution of the tax burden, see Mark Hallerberg, "Tax Competition, Political Institutions, and Democratization: The Development of State Tax Systems in Wilhelmine Germany" (Ph.D. diss., University of California, Los Angeles, 1995).

[27] Steuerzahler, Habt Acht!" *Freisinnige Zeitung*, September 9, 1907; trans. by the author.

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some states the tax on land remained more or less the same, while in others agriculture benefited from a considerable tax cut. Thus, while taxes on mobile factors converged, the overall tax burden increased on mobile factors and decreased on immobile ones.

Differences in the extension of the franchise account for this variation in land tax rates. In most states agricultural interests dominated the parliament, and they adjusted the tax system in their favor. They also increased taxes on urban labor and capital when national demands for revenue forced the states to increase their own taxes. In parliaments that were elected with more open franchises, however, large agricultural interests were taxed more and the system in general was more progressive than in states with more closed political systems.

The instrument states used to tax capital and labor more heavily was the general income tax. By 1914 every state had replaced its old method of assessing income with a general income tax. Unlike some of the rudimentary income taxes in use in 1873, each tax also addressed capital income, which meant that capital was then addressed uniformly throughout Germany.[28] On average the top tax rate was twice as high as it was in 1873, up from a mean of 2.22 percent in 1873 to 4.76 percent in 1914, and Figure 2 indicates that every state levied a higher tax rate in 1914 than in 1873. Thus the rate had increased from an effective rate of 0 percent in many states to almost 5 percent. The top tax rates also converged. By 1914 fifteen of the twenty-two states maintained the same top rate of 5 percent. The standard deviation also dropped to almost a third of its previous level, or to .48 from 1.2.

The tax rates were not so uniform for persons with low incomes. While those making 350 marks in the small states of Schwarzburg-Rudolstadt, Waldeck, and Saxon-Coburg-Gotha had to pay some income tax, an income of up to 900 marks was untaxed in Prussia. Nonetheless, even at this higher level a majority of adults, or 54 percent, paid some income tax in 1913.[29] The overall progressivity of state tax systems had also changed: while in 1873 many relied on regressive class taxes, all used a moderately progressive income tax in 1914.

[28] Key additions to these taxes included a mandatory declaration of one's income for higher-income individuals, governmental audits, and statutory penalties for underreporting income.

[29] "Übersicht der Ergebnisse der Einkommensteuer-Veranlagung für das Steuerjahr 1913," Nr. 31, Haus der Abgeordneten 22. Legislaturperiode, II. Session 1914, Rep. 77, Tit. 43, No. 89, *Geheimes Staatsarchiv Preußischer Kulturbesitz* (hereafter cited as *GStA*), 23–24. Prussia's income minimum, which was high by German standards, was low compared with England's minimum of about 3,200 marks. The Social Democrats demanded in pamphlets that the German states adopt the English minimum; see, for example, Emanuel Wurm, *Die Finanzgeschichte des deutschen Reiches* (The financial history of the German empire) (Hamburg: Erdmann Dubber in Hamburg, 1910), 69.

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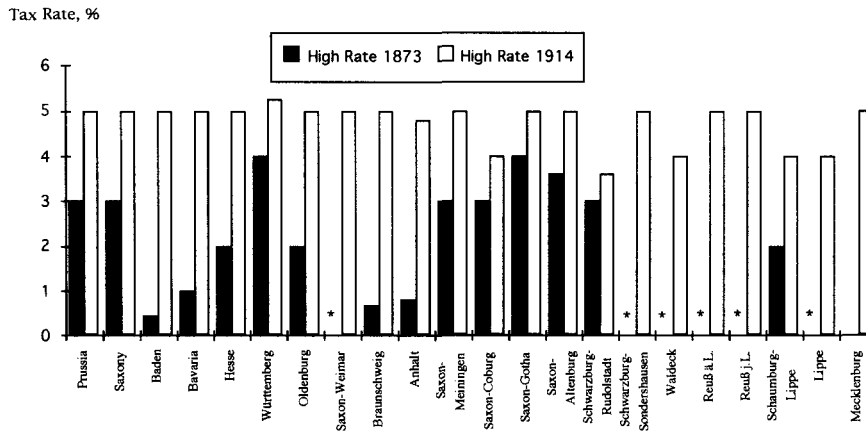

FIGURE 2
TOP PERSONAL TAX RATES IN THE GERMAN STATES
(1873 AND 1914)

*Denotes that the value is missing.

A comparison with the top tax rates in the other major European countries shows that this convergence was unique to Germany. The top international tax rates on average increased. Unlike in Germany, however, a rate convergence did not accompany the increased rates. Russia never introduced a peacetime personal tax, while the income tax that France passed just before the start of the war had a top rate of only 2 percent. These low rates contrast strongly with a top rate of 9.6 percent in Britain or 8.8 percent in the Netherlands. The box plots in Figure 3 nicely illustrate the comparatively wide range of rates present internationally in comparison with the German states. While the two groupings have similar medians, the range of possible rates varied. The size of the German states' interquartile range was effectively zero, and any value that was not 5 percent was considered an outlier. At the same time, the European interquartile range stretched almost 4 percentage points, and no German state had a top rate as low as the Russian rate or as high as the British one. In 1873 the range of rates within the German states was generally higher than the European range, but by 1914 the positions had reversed.

The type of tax used to address business and their rates also converged to a remarkable degree. Unlike in 1873, when some states used

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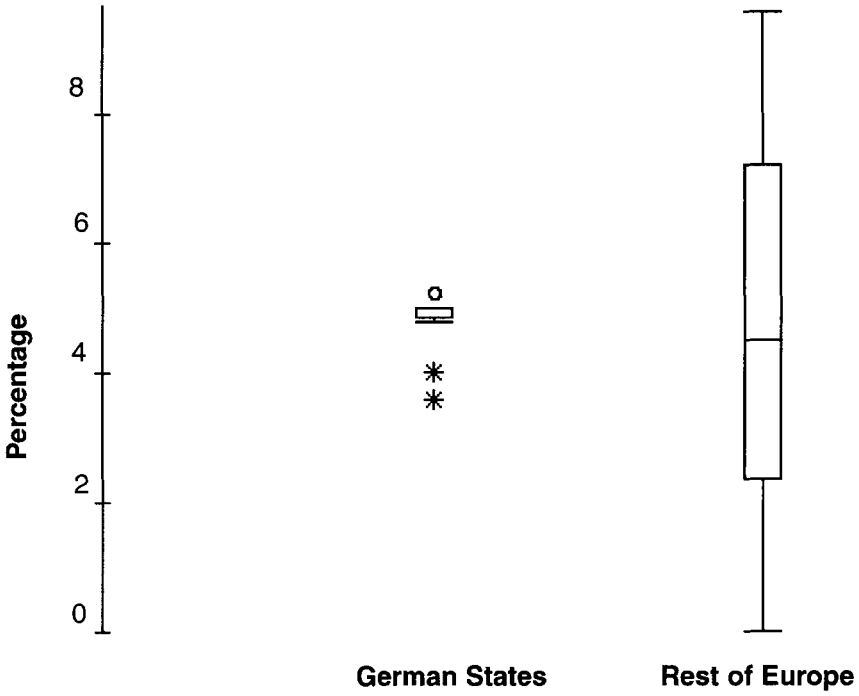

FIGURE 3
GERMAN AND EUROPEAN TOP INCOME TAX RATE[a]
(1914)

[a]Summary statistics for top personal tax rates, 1873 and 1914:

	1873	*1914*
German States		
Average top rate	2.22	4.76
Standard deviation	1.30	0.48
Other European States		
Average	2.81	4.83
Standard deviation	4.83	3.37
Standard deviation without Austria	.72	not relevant

[b] The stars in the boxplot for the German states indicate that these values fall outside two standard deviations of the median.

a business tax, two an income tax, and the others no tax at all, in 1914 every state used an income tax that treated businesses like individuals, and fourteen of twenty-two relied exclusively on the income tax. The business rates were identical to the income tax on individuals, and rates

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therefore converged for businesses as well as for individuals. The eight states that continued to use the old business tax did not modernize it, and the tax was not designed to address large firms. In 1913 it represented just .1 percent of total taxes raised by the states.[30] Businesses therefore faced a common tax rate in most parts of Germany.

Agriculture used several changes to the taxation of land to improve its position, even though it was an immobile factor that, according to tax competition theory, should have seen its tax burden increase. Figure 4 compares the tax burdens in 1873 and 1914 in terms of net proceeds and confirms that the tax burden on land decreased.[31] The median rate dropped from 5 percent in 1873 to 3.85 percent in 1914, and the top rate moved down slightly from 9 percent to 8.5 percent. Unlike the case of personal and business taxes, tax rates did not converge but rather diverged somewhat—the standard deviation increased slightly from 1.9 to 2.2 percent.

By 1914 many states had replaced the land tax with a general property tax, which in principle treated all property equally, whether it was agricultural land, city apartments, or bond issues. This tax therefore linked the tax rate on immobile land with mobile capital and could have represented an attempt by agriculture to gain any benefits from tax competition for mobile factors. Indeed, the rates for the property tax were extremely close, and seem to confirm that tax competition drove these rates together as well. In ten of the fourteen states that used a

[30] D. E. Schremmer, "Taxation and Public Finance: Britain, France, and Germany," *Cambridge Economic History of Europe* (Cambridge: Cambridge University Press, 1989), 8:482.

[31] There are several reasons why the data can be suspect, and the decrease in land tax rates may have been larger than what is estimated here. First, it is impossible to know with any certainty if a given state uniformly carried out land assessments. The timing of assessments also mattered—a state that regularly revised its records would have had a more burdensome tax than a state like Prussia, which did not commission a new land-tax assessment during the entire period, and the author could not locate assessment dates for all of the states. Figure 4 may therefore underestimate the decrease in real (as opposed to statutory) land tax rates from 1873 to 1914 if most of the states did not revise an assessment that they generally conducted between 1860 and 1875.

The figures in the graph indicate only the percentage of net value of proceeds; sales value rates are converted into net proceeds percentages by multiplying them by 77, which is their presumed proceeds value. Many supporters of agriculture within the Center Party and the two conservative parties asserted that the real multiplier was 25, and they successfully passed this figure into the assessment of the property tax in 1909. Prussian Finance Minister von Rheinbaben asserted that the true multiplier was 77, which was based on his ministry's estimates and are found in "Die Ergebnisse der Veranlagung des land- und forstwirtschaftlich benuzten Grundbesitzes zur Ergänzungssteuer für die Veranlagungsperiode 1902/04." Sent from General Tax Director High Financial Councillor Wallach to Finance Minister von Rheinbaben. 12.2.06 Rep. 151 II Nr. 2013, *GStA* (fn. 29). If the true multiplier were closer to the one that the agricultural interests favored, then the conclusion that land tax rates both decreased and diverged would be stronger.

Finally, some states that passed a general property tax continued to levy the land tax. In most cases the land tax became a more or less dead appendage, since revisions of assessments did not occur after passage of the property tax. An exception was Saxony, and the Saxon land tax is included in the figures.

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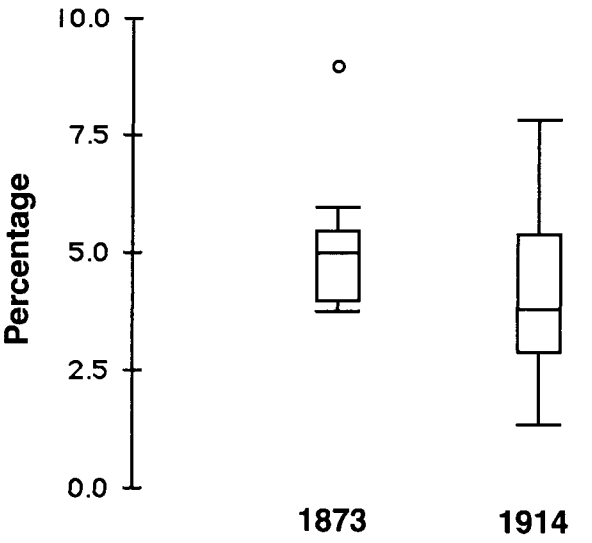

FIGURE 4
COMPARISON OF LAND-TAX RATES
(1873 AND 1914)[a]

[a]The data for this figure are found in the appendix.

general property tax the rate was either .05 percent or .055 percent. At the same time, the two open large states that introduced the property tax, Hesse and Baden, also had rates almost or exactly twice as high at .095 percent and .11 percent, respectively, which indicates some variation not present with income tax rates.[32]

Yet even under a general property tax, agriculture managed to acquire a tax break in some states, most notably in Prussia, by changing the means of assessment on agricultural property. The standard method used to determine taxable property was simply to assess the property's sale value. In 1908, however, Prussia changed the assessment of agricultural and forest land to a formula that set the property's worth at twenty-five times the yearly proceeds of the land, which meant that agricultural land thereafter paid only 50–62.5 percent of what it had

[32] These differences are fairly small but not trivial. The tax assessed the total property that one owned and not that property's return (which the income tax was designed to address). Those who were liable to pay the tax usually owned many thousands of marks in property, and a change of .055% in the rate did affect one's tax bill. A person who owned a 50,000 mark estate paid 25 marks in tax in Saxony but 55 marks in Baden.

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paid the year before.[33] In Baden the tax favored only small farmers; those with property worth 25,000 marks or less paid no tax at all, whereas those with 100,000 paid the full rate. This meant that large agricultural landowners in Baden paid double the tax paid by the large agricultural landowners in Prussia, which is not surprising given Baden's relatively open political system and Prussia's three-class electoral system.

It is also important to see that the use of this tax represented a significant cut in state taxes from what agricultural land paid when the empire was created. While in 1873 Prussia levied a 4 percent tax on the assessed net proceeds of agricultural land, the effective 1908 rate was 1.38, or 35 percent of the tax agriculture paid in 1873.[34] The greatest disparity, however, occurred in the politically closed but highly industrialized state of Saxony, but only for four years. The parliament passed the general property tax in 1902, but agricultural landowners managed at first to exclude their holdings from the new tax altogether. But after extreme criticism of the move in the press, the Social Democratic victory in Saxon Reichstag districts in 1903, and huge street demonstrations in 1905–6, the conservatives finally relented, and parliament reluctantly extended the tax to agricultural property as well.[35] Other states continued to use the old land and buildings taxes, including most notably Bavaria and Württemberg. (See the appendix for a full list of the changes.)

One qualification to these results involves local taxes. Where states introduced a general property tax, they transferred most or all of the land tax to the localities, and, to the extent that localities simply continued the land tax, the new state property tax represented an additional burden. While data on local taxes in the small states are scarce, figures for the largest state, Prussia, indicate that the transfer of the land tax represented a true tax break for large landowners. The landed nobility lost its tax-exempt status at the state level after 1861 but continued to possess it at the local level, which meant that after the trans-

[33] Figure computed from Peter-Christian Witt, *Die Finanzpolitik des Deutschen Reichs von 1903 bis 1913* (The financial politics of the German empire from 1903 through 1913) (Lübeck and Hamburg: Matthiesen Verlag, 1970), 126 fn. 455.

[34] For instance, in 1914 one multiplied the production assessment by 25, then levied a tax of .055%; this meant that the owner of a piece of land that produced 10,000 marks of grain in 1873 would pay 400 marks of tax in 1873 but only 137.5 marks in 1914.

[35] See Donald Warren, *The Red Kingdom of Saxony: Lobbying Grounds for Gustav Stresemann, 1901–1909* (The Hague: Martinus Nijhoff, 1964), 75–76; Eugen Baltes, "Die deutschen Vermögensteuern," *Finanzarchiv* 32, no. 2 (1915), provides greater detail on the assessment methods the smaller states used, although some of his figures, such as the tax rate for Hesse, are clearly inaccurate.

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fer of the land tax in 1891, landowners in whole sections of the eastern part of Prussia paid only the general income tax.[36]

The discussion of local taxes also reinforces the conclusion that taxes increased on mobile labor and capital relative to labor. Higher income tax rates on upper incomes generally placed a disproportionate burden on urban owners of capital. Higher rates had little effect on landowners for two reasons—many had much of their wealth sunk in land, and few of them made enough money to pay the top rate. At the same time localities earned most of their revenue through a supplement to direct state taxes, which by the turn of the century often meant just to the income tax. These supplements were not trivial: in Prussia in 1910 they ranged from 90 to 400 percent.[37] This meant that in some parts of the state persons in the highest tax bracket paid 25 percent of their income in income tax. This high variation in local rates is not surprising, of course, because the localities provided most of the fundamental public goods, such as schools and infrastructure. Moreover, not only were few agricultural landowners in the top income tax brackets, but the highest local tax supplements were usually in the cities. These local taxes magnified the increased burden on capital relative to land.

A final point should be made about the tax rates under discussion here: although to a modern observer the rates appear quite low and the range of possible rates narrow, at that time they did not. In the late nineteenth and early twentieth centuries it was the popular belief that peacetime tax rates should not be higher than a few percentage points. The state did not provide a wide variety of public goods, and when social insurance did exist, such as in Germany after the 1880s, employees and businesses paid most of the bill with little direct state involvement.[38] Most of the Reich budget went to military spending, and only in times of war or when war was thought to be imminent did populations actively support increased spending.[39] Indeed, in 1914 the highest

[36] This tax cut, while appealing to the pocketbooks of the largest landowners, potentially also meant a loss of political power, since tax payments determined one's class in the three-class voting system. The Landtag assured that landowners did not lose any electoral strength when it passed legislation that stipulated that, for voting purposes only, landowners were treated as though they still paid the state levy. For a social democratic view of this practice, see Robert Leinert, *Die Preußischen Landtagswahlen* (The Prussian parliamentary elections) (Berlin: Buchhandlung Vorwärts Paul Singer, 1913), 17.

[37] Witt (fn. 33), 22.

[38] Of the three parts of the welfare state that Bismarck introduced, that is, health insurance, accident insurance, and old-age pensions, the state contributed only to old-age pensions, and then only 50 marks per year. Martin Kitchen, *The Political Economy of Germany, 1815–1914* (Montreal: McGill-Queen's University Press, 1978), 177.

[39] For a persuasive discussion of how World War I changed this attitude, see Alan T. Peacock and J. Wiseman, *The Growth of Public Expenditure in the United Kingdom* (Princeton, N.J.: National Bureau of Economic Research, 1961).

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credible tax rate in the industrialized world was in Britain, and that rate was only 9.6 percent, which by today's standards appears quite low. Italy did impose a 20 percent marginal top rate, but in practice no Italian ever paid anything close to this rate because citizens considered it unbearably high. A contemporary commentator, Erwin Seligman, noted in a discussion of Austria that "a tax of twenty per cent on incomes in times of peace was, of course, entirely unendurable . . . [and] the ordinary taxpayer considered it perfectly justifiable to evade the tax as far as possible."[40]

How well do the two theories discussed previously, political development and tax competition, explain the tax systems that existed in 1914? The predictions of the political model that concern the taxation of land were largely accurate. In states with closed political systems that guaranteed rural dominance, land taxes were cut. This occurred even in states like Prussia and Saxony, which were heavily industrialized. In states with more open political systems agriculture did not receive as much assistance, and when it did receive a tax cut, large landowners paid more tax than small landowners. What the political argument cannot explain is why tax rates on income and capital converged. Competition for these resources apparently did force a harmonization of rates, but tax competition does not explain why the rates converged upward instead of downward.

Upward Convergence

Scholars who analyze tax competition usually expect competition to force tax rates downward. What then explains the upward convergence in this case? The most obvious solution is that states followed Sinn's advice for the European Union and actively coordinated their rates; through cooperation they avoided the Prisoner's Dilemma inherent in the situation, and all benefited from high marginal rates and higher taxes. There is, however, no evidence that states cooperated in this matter. Although finance ministers did meet occasionally, they generally concerned themselves with how to prevent the Reich from infringing on their tax systems through the introduction of a national income tax. The first significant effort to coordinate tax policy did not occur until

[40] Seligman, *The Income Tax* (New York: MacMillian Company, 1914), 331. He also made a similar statement for Italy: "Obviously an income tax running up to twenty per cent, to which all manner of other kinds of local taxes are to be added, would indeed be unendurable if enforced to the hilt" (p. 353).

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1918, when the states feared a massive flight of capital after the war.[41] It is also possible that such meetings were not necessary; states could have signaled their intentions to each other, making any cooperation tacit.[42]

Yet a closer look at the individual states indicates that there was tax competition. Greater demands on the states' budgets forced all of them to raise their tax rates, although the evidence suggests that Prussia kept its rates lower than others would have liked. Prussia thus assumed the role of the lowest-common-denominator state. During the first twenty years of the empire, the states had little reason to raise their tax rates, as there was at first an inflow of French war reparations. The economic downturn that began in 1873 affected Reich revenue as well as state revenue, and the national government raised significantly the level of matricular contributions it demanded from the states.[43] National developments saved the states from having to raise taxes to balance their own budgets. In 1879 Bismarck, with support from the so-called marriage of iron and rye, successfully pushed significantly higher tariffs through the Reichstag and Bundesrat. A lesser-known part of the bill was the Franckenstein clause, which stipulated that any revenue over 130 million marks from the tariffs must go directly to the states.[44] In the 1880s this clause gave the states more income from the customs revenue than they paid back in the form of matricular contributions, and most states either cut taxes or transferred part of their revenues to the localities. Bismarck's successor, Caprivi, passed a series of tariff reductions between 1891 and 1893; not only did this anger agricultural interests but it also quickly led to budget deficits in the states. At this time Prussia introduced its first general income tax, and other states soon followed or increased the marginal rates on their existing taxes. The situation became worse when in 1896 the Reichstag limited the amount of revenue the states could receive through the Franckenstein clause, and in 1904 it abolished the clause entirely.[45] The Reich also decreased the level of

[41] See especially "Ausgleichung der einzelstaatlichen Einkommensteuergesetze. 1918," Rep. 77 Tit. 43 Nr. 102, *GstA* (fn. 29); and "Steuerflucht. Abwanderung nach dem Ausland. Verhandlungen über die Einführung eines Gesetzes gegen die Steuerflucht. 1918," Rep. 151 II Nr. 2009, *GstA* (fn. 29).

[42] I thank Susanne Lohmann for emphasizing this point to me.

[43] As mentioned before, Article 70 of the Reich Constitution stipulated that the national government could not run an ordinary budget deficit. If its revenues did not cover expenditures, the states were required to make up the difference in proportion to their populations.

[44] A succinct discussion of the politics behind the passage of the tariffs is found in Kitchen (fn. 38), 152–53.

[45] Peter-Michael Prochnow, "Staat im Wachstum: Versuch einer finanzwirtschaftlichen Analyse der preußischen Haushaltsrechnungen, 1871–1913" (State in growth: Attempt at a financial-economic analysis of the Prussian budget receipts, 1871–1913) (Ph.D. diss., University of Münster, 1977), 58–59.

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matricular contributions it demanded from the states, but the net flow of revenue had clearly changed directions. While from 1883 to 1893 the states collectively received an average of 48.6 million marks per year from the national government, from 1899 to 1908 they had to pay collectively an average of 22.3 million to the Reich, a turnaround of over 70 million marks.[46] Therefore the surprise is not that tax rates increased, but rather that they increased so little.

The reason rates stayed so low was Prussia's domination of the domestic scene and her use of railroad revenue. Prussia was the largest state, with roughly two-thirds of the total land mass and 60 percent of the total population. Many of the Reich ministries were identical to the Prussian ones, and the Prussian king was also the kaiser for the Reich. While large East Elbian landowners demanded recognition for their perceived economic decline, the heavily industrialized areas in and around Berlin and in the Ruhr region were just as likely to attract the attention of investors. The finance ministers of other states could not ignore their overbearing neighbor. If they raised their tax rates above Prussia's, it was likely that capital would flee for the opportunities that their big brother could provide. Prussia represented such a dominant presence that policymakers "would have had to close out the option of going appreciably above the Prussian tax rates" when considering ways in which to balance the budget.[47]

Prussia was able to keep the prevailing income tax rate lower than other states would have liked because of its significant revenue from railroads, proceeds that other states could not generate. Because the railroad industry operated under economies of scale, Prussia, with its large absolute size, could make large profits. Between 1879 and 1885 Prussia nationalized virtually all of the railroads on its territory, and it subsequently ran them as a monopoly. In 1880 the industry contributed a surplus of only 3 million marks to the Prussian budget, but by 1895 the annual surplus was averaging 397 million marks per year; in comparison, in 1898–99 the total take from the income tax was a third as high, or just 133 million marks.[48] Indeed, by 1913, 75 percent of all

[46] In 1912 the level of net transfers to the Reich had increased even more, to 51.9 million marks. Figures computed from Wilhelm Gerloff, *Die Finanz und Zollpolitik des deutschen Reiches* (The politics of finance and tariffs in the German empire) (Jena: Verlag von Gustav Fischer, 1913), 522–23.

[47] Ibid., 377.

[48] Rainer Fremdling, "Freight Rates and State Budget: The Role of the National Prussian Railways, 1880–1913," *Journal of European Economic History* 9 (1980), 34. Income tax figures are from Metzger and Weingarten (fn. 24), 305. Wilhelm Gerloff states that for the budget year 1893–94 Prussia grossed 1,522 million marks and spent 853 million, which implies a surplus of 669 million, but these figures probably exclude the repayment of railroad debt. Gerloff (fn. 46), 256.

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state revenue came from public enterprises, up from 58 percent in 1875.[49] Thus, while Prussia increased tax rates somewhat, they could be kept much lower than would have been necessary had the railroads not been nationalized. Prussia was able to use these funds to keep marginal personal tax rates low and to cut taxes on agriculture. The smaller states could not produce similar profits, and therefore had fewer options for changing their own tax systems. Whereas states like Saxony had higher per capita incomes than Prussia and hence generated more income from the same marginal tax rate, other states like Baden had higher taxes on property and especially on large agricultural landowners. Finally, some of the smaller states faced almost chronic fiscal crises, and there were concerns that small states would someday go bankrupt.[50] They had to borrow heavily to pay their bills.

Conclusion: What Are the Implications for the European Union?

Some trends are clear. Tax rates for mobile and immobile factors differed in 1873. By 1914 there were few differences in taxes on mobile factors among states that often had very different political systems, and the effects from tax competition dominated. One surprise, however, is that these factors also paid more tax. Capital in particular was tax-exempt in most states in 1873, but by 1914 the income tax covered profits from capital in every state, and several governments levied an additional general property tax that assessed capital regardless of its rate of return. This result contradicts the perception that the state did all it could to help business develop.[51] Taxes on high-income labor also increased notably; the tax rate was higher in every state, with over 90 percent of the Reich's population living in a state with a top rate of 5 percent or 5.25 percent. Hans-Werner Sinn's fear that competition must inevitably drive down tax rates is unfounded in this case. It is also clear that the immobile factor, land, was not left with the tax burden. Paradoxically, agriculture received the greatest breaks in the two most industrialized states, Prussia and Saxony, while in less developed

[49] Although railroads became the principal source of income, the state had other businesses as well, including interests in porcelain and coal production, and it collected revenue from its considerable holdings of land. The figure is from Schremmer (fn. 30), 419.

[50] For a brief discussion of the plight of the small states, see Jürgen von Kruedener, "The Franckenstein Paradox in the Intergovernmental Fiscal Relations of Imperial Germany," in Peter-Christian Witt, *Wealth and Taxation in Central Europe* (New York: Berg, 1987), 111–24.

[51] See especially Alexander Geschenkron, *Economic Backwardness in Historical Perspective: A Book of Essays* (Cambridge: Harvard University Press, 1962).

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Baden, Bavaria, and Württemberg agricultural land faced higher taxes. The likely reason for this disparity involved politics—the southern states had more open and competitive political systems than their northern neighbors.

How relevant is this discussion for the European Union? The European states appear to have more opportunities to avoid a forced convergence. Unlike states in Wilhelmine Germany, modern governments can alter the mix of public goods they offer to such a degree that some persons would relocate to (or remain in) high-tax jurisdictions in exchange for a greater provision of public goods. Yet this option is not a realistic solution to retain capital. Persons usually receive public goods at their residence, while capital flows wherever it receives the highest rate of return, and it is difficult to tie capital tax payments to public goods. Labor mobility can also make it difficult for governments to maintain current tax rates and a concomitant level of social spending. States that provide a generous package of social benefits will experience a flood of persons seeking to take advantage of them, while capital will refuse to pay any net burden and will leave. A state that tried to maintain current levels of social spending "would face emigration of the lucky that are supposed to give and immigration of the unlucky that are supposed to receive."[52]

Yet the burden on capital and income did increase in the German states, and the two reasons why rates moved upward provide possible alternatives for the Union states to avoid a forced downward convergence. First, the national government in Berlin required the German states to transfer increasing amounts of revenue to the central government. The transfers affected all of the states in more or less the same way, and they had to increase revenues. An analogous solution within Europe is for the states to transfer increasing amounts of revenue to the Union so that the "floor" level of expenditures is fairly high. Under the Prisoner's Dilemma even if both players defect, the states must collect some minimum amount of revenue to remain fiscally solvent; tax rates therefore do not drop to zero. If states are externally constrained to raise a given amount of revenue, this can affect the "defection" level of tax collection.

A related option is for the states simply to transfer taxes on the most mobile factors to the European level, which can be called the "German solution." Indeed, the current fiscal structure of Germany is instructive; states like Bavaria and Hesse no longer compete with each other for mobile factors with differing income tax rates because the national government collects all of the income taxes and then redistributes them

[52] Sinn (fn. 10), 502.

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back to the states. If the transfers are sufficiently large, states can maintain higher levels of social spending; only the ultimate source of the funds will change. This solution is indeed how the German states ended tax competition; the national government now collects the income tax and then redistributes the funds to the states.

Both of these options involve a significant transfer of sovereignty from the national governments to the Union and parallel calls by other authors for a "deepening" of the European Union. Both Barry Eichengreen and Paul Krugman, for instance, indicate the need for further development of "fiscal federalism" within Europe to compensate those who lose from further economic integration.[53] At least in the short term, however, the transfer of significant amounts of revenue, much less whole tax instruments, to the Union level seems politically infeasible. Voters on referenda on the Maastricht Treaty in France and Denmark expressed general unease over any further transfer of authority to Brussels, and Great Britain has expressed outright opposition to further deepening. In the longer term both options do nonetheless represent ways to avoid a downward convergence of tax rates on mobile factors if the political will can be found to enact them.

A second point concerns the central role of Prussia in setting tax rates in Wilhelmine Germany; is there a European Union equivalent to Prussia? There currently appears to be no "Stackelberg" leader in the European Union to lead the states unilaterally to higher tax rates. The state that comes closest to this role is modern Germany because of the centrality of its economy and its currency. Yet its failure in 1989 to maintain a modest 10 percent withholding tax on interest income in the face of an enormous capital outflow indicates that capital is already so mobile and investment opportunities so widespread outside of Germany that it cannot assume Prussia's role.[54] An intriguing alternative is the possible creation of a core group within the European Union composed of Germany, France, the Benelux countries, and probably Austria. Speculation usually concerns a multitrack Europe on monetary policy, but there is no reason to believe that it could not exist for fiscal policy as well. Nevertheless, coordination among even this small group would be difficult. France relies more on indirect taxes such as the value-added tax, while Germany uses more direct taxes such as the income tax; a

[53] Eichengreen, *Should the Maastricht Treaty Be Saved?* Princeton Studies in International Finance, no. 74 (December 1992), 32–37; and Krugman, "Lessons of Massachusetts for EMU," in Francisco Torres and Francesco Giavazzi, eds., *Adjustment and Growth in the European Monetary Union* (Cambridge: Cambridge University Press, 1993), 241–61.

[54] Sinn (fn. 1), 4.

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common front would therefore require political will. The Union is also expanding northward and eastward, and each additional member reduces the overall influence that the core group can have over the others.

The European states could also actively coordinate their tax rates, or, in the parlance of game theory, all cooperate instead of all defect. So far, however, member states have had only limited success coordinating tax policy. The best the states have managed is a baseline level of taxation for value-added taxes, with little progress on the taxation of capital or mobile labor.[55] The bulk of this article indicates that tax competition is a real danger to the Union if member states do not act more forcefully to coordinate their tax rates on capital and labor.

A final note should be added about the relevance of politics. The economists' prediction that increased factor mobility necessarily shifts the tax burden from mobile to immobile factors must be qualified. If the immobile factor has considerable power within the government, there is no reason to expect it to pay more taxes. Indeed, the influence of farmers in France, Germany, and the United States, which is out of proportion to their absolute numbers, indicates that this lesson is as relevant today as it was a century ago.

Appendix

Table 2
Top Personal Tax Rates: German States and Rest of Europe

German States	*Type*	*High % 1873*	*Type 1914*	*High % 1914*	*Minimum Income, 1914*
Prussia	class and classified	3	income	5	900
Saxony	general income (1874)	3	income	5	400
Baden	class	0.44	income	5	900
Bavaria	partial income tax	1	income	5	600
Hesse	income tax	2	income	5	500
Württemberg	service and occupation	4	income	5.25	500
Oldenburg	general income	2	income	5	400
Saxony-Weimar	income tax	—	income	5	500
Brunswick	personal tax	0.66	income	5	900
Anhalt	business tax	0.8	income	4.8	600
Saxony-Meiningen	class and classified	3	income	5	900
Saxony-Coburg	class and classified	3	income	4	350
Saxony-Gotha	class and classified	4	income	5	350
Saxony-Altenburg	class and income	3.6	income	5	450

[55] Albert Rädler, "Where Does Tax Harmonization Stand Today?" *EC Tax Review* 4 (1993), 198–99.

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TABLE 2 (*cont.*)

German States	*Type*	*High % 1873*	*Type 1914*	*High % 1914*	*Minimum Income, 1914*
Schwarzburg-Rudolstadt	personal	3	income	3.6	350
Schwarzburg-Sondershausen	class	—	income	5	500
Waldeck	income	—	income	4	350
Reuß Older Line	income	—	income	5	600
Reuß Younger Line	class and classified	—	income	5	650
Schaumburg-Lippe	class	2	income	4	450
Lippe	class and classified	—	income	4	500
Mecklenburg	none	0	income	5	200

Non-German States	*Type*	*High % 1873*	*Type 1914*	*High % 1914*
Austria	income	10	income	6.7
Denmark	none	—	income	2.5
England	income	1.25	income	9.6
France	none	0	income	2
Norway	part of Sweden in 1873	—	income	5
Netherlands	personal	—	income	8.8
Russia	none	0	[none]	0
Sweden		—	income	4

SOURCES: Adolf Buchenberger, *Finanzpolitik und Staatshaushalt im Großherzogtum Baden in den Jahren 1850–1900* (Financial politics and budget in the grand duchy of Baden in the years 1850–1900) (Heidelberg: Carl Winter's Universitätsbuchhandlung, 1902), 168–69; "Badisches Einkommengesetz in der Fassung vom 1. Juni 1910," *Finanzarchiv* 30, no. 2 (1913), 388–98. The following citations are in Wilhelm Gerloff and Franz Meisel, *Handbuch der Finanzwissenschaft,* vol. 3 (Handbook of financial knowledge) (Tübingen: Verlag von J. C. B. Mohr, 1929): Paul Haensel, "Der Staatshaushalt und das Finanzsystem Großbritaniens," in William Gerloff and Franz Meisel, eds., *Handbuch der Finanzwissenschaft,* vol. 3 (Handbook of financial knowledge (Tübingen: Verlag von J. C. B. Mohr, 1929), 86; William Oualid, "Das Budget und das Finanzsystem Frankreichs," in William Gerloff and Franz Meisel, eds., *Handbuch der Finanzwissenschaft,* vol. 3 (Handbook of financial knowledge) (Tübingen: Verlag von J. C. B. Mohr, 1929), 135; and Paul Szende, "Der Staatshaushalt und das Finanzsystem Oesterreichs und Ungarns," in William Gerloff and Franz Meisel, eds., *Handbuch der Finznzwissenschaft,* vol. 3 (Tübingen: Verlag von J. C. B. Mohr, 1929), 202; Kossuth Kent Kennan, *Income Taxation: Methods and Results in Various Countries* (Milwaukee: Burdick and Allen, 1910), 53, 166, 191; "Lippisches Gesetz über die staatliche Einkommensteuer," *Finanzarchiv* 31, no. 1 (1914), 443, 447; "Sachsen-Coburgisches Einkommengesetz vom 2. Dezember 1908 mit Novellen," *Finanzarchiv* 31, no. 2 (1914), 256–57; "Sachsen-Altenburgisches Einkommensteuergesetz vom 4. Januar 1910 mit Novelle vom 12. Dezember 1910," *Finanzarchiv* 32, no. 2 (1915), 370; "Schwarzburg-Sondershausener Einkommensteuergesetz vom 15. Februar 1912," *Finanzarchiv* 33, no. 2 (1916), 379; "Die Einkommensteuersätze in Deutschland," *Kölnische Zeitung,* October 23, 1908; Neubrand, "Die Belastung mit direkten Staatssteuern in Preussen, Bayern, Sachsen, Württemberg und Baden," *Finanzarchiv* 33, no. 2 (1916), 259; Johannes Popitz, "Einkommensteuer," in Ludwig Elster, Adolf Weber, and Friedrich Wieser, eds., *Handwörterbuch der Staatswissenschaften* (Hand dictionary of financial knowledge), 4th ed. (Jena: Verlag von Gustav Fischer, 1926), 3:444; "Schwarzburg-Rudolstadt Einkommengesetz vom 28. Juni 1913," *Finanzarchiv* 33, no. 2 (1916), 346; Adolf Wagner, *Finanzwissenschaft,* sec. 4, *Specielle Steuerlehre* (Financial knowledge, sec. 4, Special tax lessons) (Leipzig: C. F. Winter'sche Verlagshandlung, 1901), 102, 157, 323–24, 543, 546, 483, 492, 495, 551–52, 554, 557, 569, 572.

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TABLE 3
BUSINESS TAXES

State	*Type, 1873*	*Type, 1914*
Prussia	business tax	income tax
Saxony	a. general income tax b. business tax	income tax
Baden	none	income tax
Bavaria	capital rent tax	a. income tax b. capital rent tax c. business tax
Hesse	a. general income tax b. business tax	income tax
Württemberg	business tax	a. income tax b. capital rent tax c. business tax
Oldenburg	none	income tax
Saxony-Weimar	none	income tax
Brunswick	business tax	a. income tax b. business tax
Anhalt	none	income tax
Saxony-Meiningen	none	income tax
Saxony-Coburg	none	income tax
Saxony-Gotha	none	income tax
Saxony-Altenburg	none	a. income tax b. business and capital tax
Schwarzburg-Rudolstadt	business tax	a. income tax b. business tax
Schwarzburg-Sondershausen	none	income tax
Waldeck	business tax	a. income tax b. business tax
Reuß Older Line	none	income tax
Reuß Younger Line	none	income tax
Schaumburg-Lippe	business tax	income tax
Lippe	business tax	a. income tax b. business tax
Mecklenburg	business tax	a. income tax b. business tax

SOURCES: Kybitz, "Der Staatshaushalt des Herzogtums Braunschweig in den Jahren 1833/86," *Finanzarchiv* 5 (1888), 731; Johannes Popitz, "Einkommensteuer," in Ludwig Elster, Adolf Weber, and Friedrich Wieser, eds., *Handwörterbuch der Staatswissenschaften* (Hand dictionary of financial knowledge), 4th ed. (Jena: Verlag von Gustav Fischer, 1926), 3:444; Eckart Schremmer, "Föderativer Staatsverbund, öffentliche Finanzen und Industrialisierung in Deutschland," in Rainer Fremdling and Hubert Kiesewetter, eds., *Staat, Region und Industrialisierung* (State, region, and industrialization) (Ostfindern: Scripta Mercaturae Verlag, 1985), 16; Adolf Wagner, *Finanzwissenschaft*, sec. 4, *Specielle Steuerlehre* (Financial knowledge, sec. 4, Special tax lessons) (Leipzig: C. F. Winter'sche Verlagshandlung, 1901), 102, 159, 322, 510, 527, 557.

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TABLE 4
PROPERTY TAXES

State	*Type, Means of Assessment*	*Rate 1873 (%)*	*Type 1914*	*Rate 1914 (%)*
Prussia	a. land tax, net proceeds	4	general property tax	0.055
	b. buildings tax, use value	2		
Saxony	land tax (1874), net proceeds	4	a. general property	0.05
			b. land tax	4
Baden	a. land tax, av. sale price	0.44	general property tax	0.11
	b. buildings tax, sale price	0.44		
Bavaria	a. land tax, gross proceeds	1.67	a. land tax, net proceeds	2.33
	b. buildings tax, rental, floor	1.67	b. house tax, rental, floor	—
Hesse	a. land tax	—	general property tax	0.095
	b. buildings tax, 1/25 sales	1.8		
Württemberg	a. land tax, net proceeds	5	a. land tax, net proceeds	2
	b. building, capital value	4	b. building, capital value	3
Oldenburg	a. land tax, net proceeds	9	a. general property tax	0.05
	b. buildings tax, rental value	6	b. land tax	—
			c. buildings tax	—
Saxony-Weimar	land tax	quota	a. general property tax	0.05
			b. land tax	—
			c. buildings tax	—
Brunswick	a. land tax, net proceeds	—	a. general property tax	0.055
	b. buildings tax, rental value	—	b. land tax	—
			c. buildings tax	—
Anhalt	a. land tax, lease value	0.25	a. land tax, net proceeds	0.5
	b. buildings, capital value	0.008		

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TABLE 4 (*cont.*)

State	*Type, Means of Assessment*	*Rate 1873 (%)*	*Type 1914*	*Rate 1914 (%)*
Saxony-Meiningen	a. land tax	—	a. general property tax	0.05
	b. buildings tax	—	b. land tax	—
			c. buildings tax	—
Saxony-Coburg-Gotha	a. land tax	—	a. land tax	—
	b. buildings tax	—	b. buildings tax	—
Saxony-Gotha	a. land tax	—	general property tax	0.05
	b. buildings tax	—		
Saxony-Altenburg	a. land tax	—	a. land tax	—
	b. buildings tax	—	b. buildings tax	—
Schwarzburg-Rudolstadt	a. land tax, net proceeds	8	a. land tax	—
	b. buildings tax, use value	4	b. buildings tax	—
Sondershausen	a. land tax, net proceeds	6	a. land tax	6
	buildings tax, use value	2.5	b. buildings tax	2.5
Waldeck	land tax	—	land tax	—
Reuß Older Line	a. land tax, net proceeds	3.8	general property tax	0.05
	b. buildings tax, use value	3.8		
Reuß Younger Line	land tax	—	land tax	—
Schaumburg-Lippe	a. land tax w/net proceeds	5	general property tax	0.0625
	b. buildings tax, av. value	2		
Lippe	land tax	—	a. general property tax	0.06
			b. land tax	—
			c. buildings tax	4
Mecklenburg	agricultural tax, rental value	1	general property	0.05

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TABLE 4 (*cont.*)

SOURCES: Eugen Baltes, "Die deutschen Vermögensteuern," *Finanzarchiv* 32, no. 2 (1915), 270; Adolf Buchenberger, *Finanzpolitik und Staatshaushalt im Großherzogtum Baden in den Jahren 1850–1900* (Financial politics and budget in the grand duchy of Baden in the years 1850–1900) (Heidelberg: Carl Winter's Universitätsbuchhandlung, 1902), 168–69; Alexander Hoffmann, *Die direkten Staatssteuern im Königreich Sachsen* (Leipzig: Verlag von Jäh & Schunke, 1906), 44; Kybitz, "Der Staatshaushalt des Herzogtums Braunschweig in den Jahren 1833/86," *Finanzarchiv* 5 (1888), 726; Neubrand, "Die Belastung mit direkten Staatssteuern in Preussen, Bayern, Sachsen, Württemberg und Baden," *Finanzarchiv* 33, no. 2 (1916), 248, 255; Pistorius, "Vermögensteuer und Landwirtschaft mit besonderer Berücksichtigung der württembergischen Verhältnisse," *Finanzarchiv* 27 (1910), 30, 34–35; Adolf Wagner, *Finanzwissenschaft*, sec. 4, *Specielle Steuerlehre* (Financial knowledge, sec. 4, Special tax lessons) (Leipzig: C. F. Winter'sche Verlagshandlung, 1901), 317, 322, 147–48, 465–67, 473–74, 481, 510, 526, 546, 554, 556, 559, 573; F. W. R. Zimmermann, *Die Finanzwirtschaft des Deutschen Reichs und der deutschen Bundesstaaten zu Kriegsausbruch 1914* (Berlin and Leipzig: G. J. Göschen'sche Verlagshandlung, 1916), 99, 115, 131, 171, 175, 193; Eckart Schremmer,"Föderativer Staatsverbund, öffentliche Finanzen und Industrialierung in Deutschland," in Rainer Fremdling and Hubert Kiesewetter, eds., *Staat, Region und Industrialisierung* (State, region, and industrialization) (Ostfindern: Scripta Mercaturae Verlag, 1985), 17; Otto Trüdinger, "Finanzen und Steuern," in D. Bruns, ed., *Württemberg unter der Regierung König Wilhelms II* (Württemberg under the reign of King William II) (Stuttgart: Deutsche Verlags-Anstalt, 1916), 207.

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TABLE 5
STATE ELECTORAL SYSTEMS, 1873

State	*Number of Houses*	*Type of Election, 2d or Single Chamber*	*Composition*	*Secret*	*Direct*	*Eligibility*
Prussia	2	3 class	432	No	No	adult males with full rights
Saxony	2	1 man, 1 vote	80	Yes	Yes	must pay direct tax
Baden	2	1 man, 1 vote	63	Yes	No	adult males with full rights
Bavaria	2	1 man, 1 vote		Yes	No	must pay direct tax
Hesse	2	1 man, 1 vote	50	Yes	No	must pay direct tax
Württemberg	2	1 man, 1 vote	70 at large, 23"privileged"	Yes	Yes	adult males with full rights
Oldenburg	1	1 man, 1 vote	34	Yes	No	must own house estate
Saxon-Weimar	1	1 man, 1 vote	23 at large, 10 large landowners	Yes	No	adult males with full rights
Brunswick	1	?	21 high taxpayers, 10 city, 12 land, 3 church	?	No	adult males with full rights
Anhalt	1	1 man, 1 vote	2 named, 10 high taxpayers, 14 city, 10 land	?	No	adult males with full rights
Saxony-Meiningen	1	3 class	4 landowners, 4 high taxpayers, 16 others	Yes	Yes	adult males with full rights
Saxony-Coburg-Gotha	1	1 man, 1 vote	19 from Gotha, 11 Coburg	?	No	own home and pay direct tax
Saxony-Altenburg	1	3 class	9 city, 9 land, 12 highest taxpayers	?	Yes	own home and pay direct tax
Schwarzburg-Rudolstadt	1	1 man, 1 vote	4 high taxpayers, 12 others	Yes	Yes	must pay direct tax
Schwarzburg-Sondershausen	1	1 man, 1 vote	5 named, 5 high taxpayers, 5 others	?	No	adult males with full rights
Waldeck	1	3 class	15	?	?	property or direct tax
Reuß Older Line	1	1 man, 1 vote	3 named, 2 large landowners, 7 others	Yes	Yes	own home and pay direct tax
Reuß Younger Line	1	1 man, 1 vote	1 estate owner, 3 high taxpayers, 12 others	Yes	Yes	must pay direct tax
Schaumburg-Lippe	1	1 man, 1 vote	10 elected, 2 landowners, 3 reps. of occupations	Yes	Yes	adult males with full rights
Lippe	1	3 class	21	Yes	Yes	adult males with full rights

SOURCES: Bernhard Vogel, Dieter Nohlen, and Rainer-Olaf Schultze, *Wahlen in Deutschland* (Elections in Germany) (Berlin: Walter de Gruyter, 1971), 120–24; Ernst Rudolf Huber, *Deutsche Verfassungsgeschichte seit 1789*, vol. 4, *Struktur und Krisen des Kaiserreichs* (German constitutional history since 1789, vol. 4, Structure and crises of the Kaiserreich) (Stuttgart: W. Kohlhammer Verlag, 1969), 372–74, 395, 405, 409–10, 414–15, 416, 421, 432; James Clark Hunt, *The People's Party in Württemberg and Southern Germany, 1890–1914* (Stuttgart: Ernst Klett Verlag, 1975), 9.

TABLE 6
CHANGES AFTER 1873

State	*Year*	*Change*
Prussia	1893	minor reworking of the 3-class system, with electoral districts for *Wahlmänner* to be no larger than 1,750 persons, instead of just at the community level
	1906	10 additional urban seats added to the lower house
Saxony	1895	state moved to a 3-class electoral system with the indirect vote
	1909	the 3-class system was replaced with a plurality system, which gave all adult males with full rights 1 vote, those making over 1,600 marks per year 1 additional vote, those making over 2,200 marks 2 additional votes, those making over 2,800 marks 3 additional votes, those with at least one year of voluntary military service 1 additional vote, and those over 50 years old 1 additional vote, with no person allowed to have more than 4 votes; number of seats in the lower house expanded from 82 to 91 and elections once again were made direct
Baden	1904	upper house expanded by 10 to include representives from trade organizations; lower house also gained 10 additional seats and the direct vote
Bavaria	1906	direct elections under a relative majority voting system; redistricting
Württemberg	1905	"privileged" were moved up to the 1st chamber; 75 members of the lower house elected by relative majority, 17 according to proportional representation, redistricting
Hesse	1911	elections direct; persons over 50 years received 1 additional vote
Brunswick	1908	introduction of direct voting, with a milder 3-class system; those who paid the top 1/10 of the taxes were in the 1st class and received 3 votes, those paying the next 2/10 received 2 votes, and the remaining 7/10, 1 vote
Anhalt	1913	direct elections; 4 representatives from trade organizations, 3 high taxpayers, and 3 seats at large added to the chamber

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RATIONALITY IN INTERNATIONAL RELATIONS
A Game-Theoretic and Empirical Study of the U.S.-China Case

By CATHERINE C. LANGLOIS and
JEAN-PIERRE P. LANGLOIS*

I. INTRODUCTION

THE premise that states behave as rational actors in the anarchy of international relations has led to a proliferation of game models.[1] To advance the debate about their relevance, we reexamine a central game-theoretic concept of rationality, the subgame-perfect equilibrium,[2] focusing on a "countervailing" effect that is found to be involved in any equilibrium strategy. Countervailing behavior broadens our understanding of what is rational and thus holds out the promise of compatibility with observed behavior in international relations. And indeed when the data on U.S.-China relations from 1972 to 1988 are anlyzed in light of this countervailing model, we find that each country's behavior toward the other can be interpreted as rational.

In most game-theoretic studies of international relations, the behavior of the players is inferred from the a priori stipulation of the structure of the game and from various considerations on the nature of rationality and the incompleteness of information. However, there is much debate over whether the game structures introduced in the models have any relevance to the problems being addressed, and such basic doubt puts the rational strategies that are derived from them in danger of

* The authors, considering their contributions to be equal, have listed their names alphabetically.

[1] An extensive survey of that literature is given by Barry O'Neill, "A Survey of Game Models of Peace and War," in Robert Aumann and Sergiu Hart, eds., *Handbook of Game Theory*, vol. 2 (New York: Springer-Verlag, 1992).

[2] Strategies are in subgame-perfect equilibrium (SGPE) if each is best against the other(s) in any contingency. The concept of SGPE comes from Reinhart Selten, "Re-examination of the Perfectness Concept for Equilibrium Points in Extensive Games," *International Journal of Game Theory* 4 (1975).

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being consigned to irrelevance. As Jervis puts it, "How do we know that a situation resembles a Prisoner's Dilemma?"[3] In fact, it has been argued that simple observation of the interaction between states speaks against the usefulness of a game-theoretic approach, whatever the structure of the game, because it reveals allegedly irrational behavior such as inertia, cultural bias, or bureaucratic delay. So even if the relevance of a particular game structure can be argued convincingly, the rationality of real-world players' responses to it can be questioned. And such doubt is only reinforced by the technical requirements often associated with the solution concepts. For instance, equilibrium play is believed to require that players share a "common conjecture" about each other's choice of strategy,[4] a premise that is hardly credible when states search for a tacit modus vivendi and seek to adapt to an ever-changing environment.

Because our interest is in long-term relationships, we focus on the so-called repeated games and show that, in order to participate in a subgame-perfect equilibrium (SGPE), a strategy must exhibit a combination of two effects on the opponent. On the one hand, it has an *expectation* effect by which a player expresses his belief about future developments and may punish his opponent for not meeting that expectation. On the other hand, it has a *countervailing* effect by which a player uses the shadow of the future to manipulate his opponent's long-term outcome, punishing or rewarding as he sees fit. Although players are likely to entertain expectations, they need not actively punish their opponent for not meeting them, especially if they are unsure about that opponent's intentions. In fact, the countervailing effect satisfies the need for retaliation while avoiding any need for coordination.[5] We therefore focus on the countervailing strategies that rely solely on that effect and find that they considerably broaden our understanding of what is rational. Thus, bureaucratic inertia, delayed responses, reciprocity, aggressivity, and tacit bargaining can all find expression in a countervailing strategy. Moreover, when we examine the data on U.S.-China relations in light of these ideas, we find empirical support for countervailing behavior, but none for the punishment that the expectation effect could involve.

We chose to examine China-U.S. relations from 1972 to 1988, the

[3] Robert Jervis, "Realism, Game Theory, and Cooperation," *World Politics* 40 (April 1988).

[4] Loosely speaking, this means that players share the same expectation of future interaction, thus determining the path of future play. See James D. Morrow, *Game Theory for Political Science* (Princeton: Princeton University Press, 1994).

[5] If each side punishes its opponent for not meeting its expectation, those expectations must be identical or they will remain hopelessly out of equilibrium. This requires a *coordination* of expectations.

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years during which they were emerging and taking on official stature. In such a context, neither country would be expected to have a preconceived idea of the particular path the relationship would take. This is precisely the situation in which rational strategies are countervailing. And, indeed, we do find, in conducting a statistical analysis of U.S.-China interaction as coded in McClelland's World Events Interaction Survey (WEIS), that the data are consistent with their adoption.[6] When examining the data in light of our game-theoretic model, we do not need to impose a narrowly defined game structure a priori. Even more importantly, we are able to infer the parameters of the game itself from an analysis of behavior. As a result, this game-theoretic approach provides the tools for detecting possible changes in the underlying game structure itself, and the development of China-U.S. relations from 1972 to 1988 yields a case study of particular interest. Indeed, a cursory overview of this history suggests that, if a game-theoretic approach can capture the evolution of this interaction, we should expect a bifurcation of behavior and priorities when China opens its doors to economic relations with the West in 1979. We therefore break our sample into two subperiods: the period from 1972 to 1978 and that from 1979 to 1988. This partitioning is of course motivated by historical events (President Nixon's visit in 1972 and the beginning of China's open-door policy in 1979), but it also turns out to be appropriate when conducting statistical tests for break points in the data. Interestingly, two distinct game structures emerge from the analysis. During the first sample period, the U.S. appears to have Prisoner's Dilemma–like payoffs while the Chinese payoff is characteristic of a Deadlock-type game.[7] During the second period, we find a true Prisoner's Dilemma game with strong incentives on both sides to engage in cooperative behavior. Thus, while rational play in the 1980s finds expression in positive reactivity to each other's moves, prior to 1979 it takes the form of an inverse response to Chinese initiatives on the part of the U.S., a behavior that moves China to a more cooperative stance despite its Deadlock-type payoff structure.

The paper is organized as follows. In Section II we review the exist-

[6] Our characterization of SGPEs in Appendix 2 also suggests how to test whether countervailing strategies have been adopted, by searching in the data for traces of coordination. Such tests, performed on data for U.S.-China relations for the period 1972 to 1988 and reported in Appendix 4, support the hypothesis that a pure countervailing strategy rather than any other type of strategy was adopted by the two countries during the period under consideration.

[7] In 2×2 games, if C denotes cooperate, D defect, and XY the choices X by row and Y by column, a Prisoner's Dilemma structure for row means his preferences satisfy DC > CC > DD > CD. There are several Deadlock-type games. The relevant one here satisfies DD > CD > DC > CC.

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ing literature both on game-theoretic and empirical approaches to international relations and on U.S.-China relations, as we introduce our modeling and empirical approach. Section III describes the model formally in three successive sections of increasing complexity. Finally, Section IV presents the empirical work and its interpretation.

II. An Overview of Related Work

Game-Theoretic Approaches

At the risk of being simplistic, one may distinguish three main classes of game-theoretic models.[8]

1. The *finite* games, usually in matrix form, were the first to be introduced in the political science literature. They range from what O'Neill has called *proto*–game theory to the more sophisticated models of Brams and Kilgour.[9]
2. The *Bayesian* games focus on how incomplete information about the preferences of one's opponent(s) affects decisions. They have been successfully applied to the modeling of international crises and nuclear deterrence.[10]
3. The *repeated* games focus on how the shadow of the future affects present decisions. They are best known for the study of Tit-for-Tat in the Prisoner's Dilemma[11] and are well suited to the study of long-term relationships.

At the core of game theory lies the concept of equilibrium: each actor adopts a strategy that is best for all contingencies, given that all others behave similarly. But behind this simple statement stands a mountain of controversy and refinements. First, what is best depends on what is known, believed, or expected. And although the various equilibrium refinements can stretch the scope of applications and weaken the need for information, they always require a highly structured and quantified view of the decision maker. Second, in the repeated game models of long-term relationships, the number of equilibria is vast.[12] And because a strategy in one equilibrium is usually not rational against an opponent's strategy in another equilibrium,

[8] We refer here to the noncooperative models that assume individualistic actors.

[9] O'Neill (fn. 1); Steven J. Brams and D. Marc Kilgour, *Game Theory and National Security* (New York: Basil Blackwell, 1988).

[10] See Robert Powell, *Nuclear Deterrence Theory: The Search for Credibility* (New York: Cambridge University Press, 1990).

[11] Robert Axelrod, *The Evolution of Cooperation* (New York: Basic Books, 1984).

[12] The folk theorem asserts that any "individually rational" outcome (i.e., no worse than the minimax) can be supported by a trigger strategy equilibrium in a repeated game. See Drew Fudenberg and Eric Maskin, "The Folk Theorem in Repeated Games with Discounting or with Incomplete Information," *Econometrica* 54 (1986).

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there is a need for coordination.[13] But if, as argued by Downs and Rocke,[14] states engage in "tacit" bargaining to manage their relationship, how could they *agree* on how they will play in order to influence each other later on through such agreed-upon play? Third, the reality of a state's decision-making process involves constraints, habits, or cultural biases that seem difficult to reconcile with the assumption of a rational actor on the international scene. Jervis adduces such commonly observed phenomena as bureaucratic delays and inertia as evidence that state decisions are not entirely rational.[15]

Some of the above criticism may, however, be based on a misperception of the resources of game theory. As we demonstrate in Appendix 3, equilibrium can be achieved without a highly restrictive coordination requirement because the strategies we call *countervailing* allow for flexible responses to actual opponent moves as they come to pass, without requiring players to entertain a specific expectation of what these moves will be. In fact, all equilibrium strategies can be broken down into two components: a countervailing effect and the *possible* punishment of an opponent who deviates from a particular expectation. This general characterization, formally spelled out in the theorem of Appendix 2, highlights the fact that a countervailing strategy is, so to speak, at the core of any rational strategy. Indeed, the addition of a punishment for unexpected play can even seem to be an unreasonable feature for the rational decision maker who recognizes the futility of trying to impose his own expectation on an opponent who is likely to think differently.[16]

A countervailing player focuses on his opponent's discounted payoff in an attempt to manipulate it. Because of the shadow of the future, what an opponent may gain or lose today can be reversed in a discounted sense beginning tomorrow, using appropriate retaliation or reciprocation. Future moves can thus be tailored to compensate in discounted terms for present disturbances. The player adopting a countervailing strategy does not need to see his expectations fulfilled, since an

[13] For example, it is not enough to recognize that one's opponent has chosen to play a trigger strategy (which involves collaborating as long as the other players do and reverting to noncooperative play for a fixed number of turns to punish the opponent for deviating from cooperative play). Each player must understand which *particular* trigger strategy has been chosen (how many punishment turns and which precise outcome is considered as the cooperative point) and chose to adopt the same one, since, if not, the strategies do not form an equilibrium.

[14] George W. Downs and David M. Rocke, *Tacit Bargaining, Arms Races, and Arms Control* (Ann Arbor: University of Michigan Press, 1990).

[15] Jervis (fn. 3).

[16] While countervailing is inherently reciprocative, the additional punishment of unexpected play could lead to retaliations for *cooperative initiatives*! This paradox is inherent to all trigger strategy schemes in continuous games.

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unexpected move by his opponent, whether a cooperative initiative or an aggressive move, will be compensated for by retargeting the opponent's discounted payoff at the next turn. Moreover, the countervailing player can expect his behavior to be entirely optimal if he simply believes that his opponent will behave similarly but has no knowledge of which countervailing strategy his opponent will use among an extremely vast set of possibilities.

Since the focus of countervailing strategies is a determination of the *opponent's* discounted payoff, reaching some modus vivendi will build in inertia, while adjustments to unexpected moves will show up as reactivity. Thus a countervailing strategy can be highly reactive or involve inertia, it can be quasi-instantaneous or arbitrarily delayed, and it can be reciprocal, retaliative, or even counterreciprocal. Such behavioral components of strategy that have been viewed as unreconcilable with rationality thus find justification within the highly demanding SGPE concept. Moreover, a countervailing strategy is an ideal vehicle for Downs and Rocke's concept of tacit bargaining between states, since it focuses on how each side can influence the other side's payoff without presuming how he will behave.

Empirical Approaches

The relevance of mixed-motive games to the modeling of great power preferences has been examined by a number of authors.[17] Some argue that states are motivated by relative rather than absolute gains, which may create zero-sum conditions; others, such as Beer, claim that it is not possible to tell whether the game has a Prisoner's Dilemma structure.[18]

Although one might hope to resolve such questions empirically, Axelrod claims that only behaviors can be discerned and that payoffs cannot be inferred.[19] And indeed it is behavior that has been widely examined empirically and probed for evidence of reactivity and reciprocity. Since rational play must involve reactivity, such feedback is the preferred target of empirical search. One strand of literature examines arms race data for traces of reactive behavior. It is well known that empirical tests based on the Richardson model rarely reveal significant

[17] See, among others, George W. Downs, David M. Rocke and Randolph M. Siverson, "Arms Races and Cooperation," in Kenneth A. Oye, ed., *Cooperation under Anarchy* (Princeton: Princeton University Press, 1986); and Kenneth A. Oye, "Explaining Cooperation under Anarchy: Hypotheses and Strategies," in Oye, ed., *Cooperation under Anarchy*.

[18] Francis A. Beer, "Games and Metaphors," *Journal of Conflict Resolution* 30 (1986).

[19] Axelrod (fn. 11).

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reactive behavior.[20] Another large body of literature examines foreign policy interaction as it manifests itself through events data.[21] However, what is tested in all these cases is a model of behavior that is posited to be cooperative *at the outset.* The issue is to fit "equations to data sets and then to assess the degree of fit and the values of the parameters."[22]

One way of circumventing this problem is to examine the data from an atheoretical perspective, searching for causal links without modeling a priori the form those links might take. The standard methodology in this case is vector autoregression (VAR).[23] Vector autoregression is associated with causality tests (Granger causality) that determine whether the set of lagged values of a given variable adds explanatory value to the VAR. Then, instead of searching for a significantly positive coefficient on rival behavior when explaining one's own behavior, Granger causality tests for significance of the *whole set* of lagged rival behavior variables in a given VAR in explaining one's own current behavior. The use of Granger causality tests to detect reactivity has proved successful using events data, although such tests have failed to predict causal reaction in both directions when applied to arms race data.[24]

It is a return to specific modeling of behavior that bolstered the case for reactivity in arms races. Williams and McGinnis show that when expectations of rival behavior are taken into account, the data provide evidence of reactivity.[25] A rational expectations model would predict that a state's military expenditures are determined by the previous period's decision and by any new information that cropped up subsequently. Such new information would appear as the error made in

[20] See Charles W. Ostrom, "Evaluating Alternative Foreign Policy Decision-Making Models: An Empirical Test between Arms Race Models and an Organizational Politics Model," *Journal of Conflict Resolution* 21 (1977); Steven J. Majeski and David Jones, "Arms Race Modeling: Causality Analysis and Model Specification," *Journal of Conflict Resolution* 25 (1981); and Kendall D. Moll and Gregory Luebbert, "Arms Race and Military Expenditure Models: A Review," *Journal of Conflict Resolution* 24 (1980).

[21] See William J. Dixon, "Reciprocity in United States-Soviet Relations: Multiple Symmetry or Issue Linkage?" *American Journal of Political Science* 30 (1986); and Michael D. Ward, "Cooperation and Conflict in Foreign Policy Behavior," *International Studies Quarterly* 26 (1982). See also Dina Zinnes, "Three Puzzles in Search of a Researcher," *International Studies Quarterly* 24 (1980); Bruce Russett, *The Prisoner's Insecurity: Nuclear Deterrence, the Arms Race and Arms Control* (San Francisco: W. H. Freeman, 1983); and Walter Isard and Charles Anderton, "Arms Race Models: A Survey and Synthesis," *Conflict Management and Peace Science* 8, no. 2 (1985).

[22] Zinnes (fn. 21).

[23] See John R. Freeman, John T. Williams, and Tse-Min Lin, "Vector Autoregression and the Study of Politics," *American Journal of Political Science* 33 (November 1989).

[24] See Joshua S. Goldstein and John Freeman, "U.S.-Soviet-Chinese Relations: Routine Reciprocity, or Rational Expectations?" *American Political Science Review* 85 (March 1991); and idem, *Three-Way Street: Strategic Reciprocity in World Politics* (Chicago: University of Chicago Press, 1990).

[25] See John Williams and Michael McGinnis, "Sophisticated Reaction in the U.S.-Soviet Arms Race: Evidence of Rational Expectations," *American Journal of Political Science* 32 (November 1988).

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predicting current expenditures with past values. Thus the rational expectations arms race model predicts the lack of significance of past rival behavior in a state's current decision (since if the rival has behaved as expected, that behavior is already accounted for in its own past decisions and adding past rival behavior to its own past behavior to explain current expenditures would therefore be redundant) and embeds possible reactivity in a correlation of the errors made in predicting current expenditures on own past expenditures (since the error term contains the *unexpected* changes in rival behavior that warrant direct response). Williams and McGinnis do indeed find evidence of reactivity when testing such a model on U.S.-Soviet arms race data and on a wider set of data including economic indicators and events data.[26] But here again, it is behavior that is modeled and tested for; payoffs are not inferred.

The analysis of U.S.-China relations that we present here is most closely related to the work of Goldstein and Freeman and Goldstein.[27] We also use McClelland's WEIS data, and our empirical tests involve restricted VAR. Our approach differs from that of Goldstein and Freeman, however, in that we move away from the atheoretical VAR to model state interaction specifically. Like Goldstein, we analyze the U.S.-China dyad in isolation, relying on Goldstein and Freeman's finding that U.S.-China relations are relatively independent empirically from U.S.-Soviet and Soviet-Chinese relations. Goldstein begins with the description of U.S. and Chinese payoffs in a mixed-motive game and describes a method of play that would fractionally reciprocate cooperation (a kind of incremental Tit-for-Tat). He provides empirical evidence that suggests that such partial reciprocation has characterized U.S.-China relations since the 1950s. However, Goldstein does not define play in a game-theoretic sense; nor does he seek to determine empirically the payoff structure that underlies the behavior he describes. This is precisely what we endeavor to do here.

U.S.-China Relations

China officially opened its doors to the development of economic transactions with the Western world in 1978. Before then Chinese foreign trade was minimal and balanced. With the open-door policy, China's international trade soared, increasing by more than 500 percent

[26] See Michael McGinnis and John Williams, "Change and Stability in Superpower Rivalry," *American Political Science Review* 83 (December 1989).

[27] Goldstein and Freeman (fn. 24, 1990 and 1991); and Joshua S. Goldstein, "Great Power Cooperation under Conditions of Limited Reciprocity: From Empirical to Formal Analysis," *International Studies Quarterly* 39 (December 1995).

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between 1978 and 1988.[28] By 1992 China's exports represented 18 percent of its gross national product with one-third of those exports absorbed by the United States. Moreover, the U.S. is the second largest single source of imports for China after Japan. In 1990 U.S. exports to China represented 23 percent of total Chinese imports. The United States has therefore played a crucial role in the development of China's economic overtures. After Hong Kong and Japan, the U.S. is the largest investor in China, and while the sums involved are still modest by international standards, U.S. interests are represented in critical ventures because the U.S., contrary to Japan, has been willing to transfer technology to China.[29]

International trade and investment create a situation of mutual economic dependency and provide the foundation of a common interest in economic growth. But trade relations can be interrupted or disadvantaged, as was made abundantly clear by the U.S. in the wake of the Tiananmen Square massacre. Such trade disruptions are costly to both parties. "I can state unequivocally that withdrawing or conditioning MFN (most favored nation) status (to China) would be a recipe for disaster for U.S. workers, consumers and employers," declared the president of the United States-China Business Council to the U.S. Congress in 1993, as he proceeded to comment on sectors of particular importance to the U.S.: "One need look no further than the airline industry to understand the critical importance the China market represents to U.S. industry. China represents one of the world's only growing major markets for aircraft and U.S. manufacturers account for 76 percent of all Chinese purchases." But just as surely, the Chinese depend on the United States for the success of their programs of economic reform. In their discussion of whether China can be influenced, Milholin and White point to the fact that most favored nation status is "a benefit worth billions to Chinese exporters."[30]

Trade clearly enhances the possible gain from mutual cooperation, and the drastic change in trade regime that the open-door policy meant for China suggests that the structure of the relationship between the U.S. and China is likely to have changed after 1979. As pointed out by O'Leary, diplomatic considerations that exclude reference to major economic developments cannot adequately explain changes in China's in-

[28] See James E. Shapiro et al., *Direct Investment and Joint Ventures in China: A Handbook for Corporate Negotiators* (New York: Quorum Books, 1991).

[29] Ibid.

[30] Gary Milholin and Gerard White, *Bombs from Beijing: A Report on China's Nuclear and Missile Exports,* report prepared for the House Foreign Affairs Committee, U.S. Congress, May 1991.

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ternational relations.[31] In particular, one would expect to see stronger incentives to cooperate once trade relations intensify, although the circumstances that make defection attractive can still come into play: the Chinese can still gain from the sale of sensitive weaponry while the U.S. will still want to benefit from cordial relations with Taiwan.

Such circumstances suggest that a mixed-motive game reflects the reality of U.S.-Chinese relations.[32] But then, is it legitimate to represent the relative interests of these great powers identically before and after 1979? A glance at Sino-U.S. relations after Nixon's visit to China in March of 1972 leaves the observer groping for the [sound] foundations of the common interest. While Nixon's visit was hailed by some as marking "the emergence of a new positive era internationally," others feared that Nixon "would lose more in Japan and Russia than he would gain in Peking."[33] In the absence of formal diplomatic relations, liaison offices were established in 1973, but relations between the U.S. and China then slackened in subsequent years. In the words of Choudhury, many Asian observers simply regarded the Nixon-Kissinger policy as a trade-off of Vietnam for Taiwan.[34] The development of economic relations in the 1970s was also timid. Despite U.S. enthusiasm in the wake of the Canton Trade Fair of 1972, the two countries remained relatively insignificant trading partners in the pre-open-door era. Miller reports that by 1977 U.S. exports to the People's Republic of China represented a mere 0.1 percent of all exports, while the U.S. overall represented only 2.5 percent of China's imports and exports.[35]

On the face of it, it does not seem likely that U.S.-China interests would fit the mixed-motive game model in the decade of the 1970s. Casual observations of the facts are more suggestive of a zero-sum interaction or perhaps a game structure such as Deadlock, where defection by both parties actually provides higher payoff than mutual cooperation. But if this is the case, what behavior can be expected of these powers?[36]

[31] See Greg O'Leary, "China's Foreign Relations: The Reintegration of China into the World Economy," in Bill Brugger, ed., *China since the Gang of Four* (London: Crown Helm, 1980).

[32] Well-known mixed-motive 2×2 games include the Prisoner's Dilemma, Chicken, and the Stag Hunt.

[33] William G. Miller, *The People's Republic of China's United Front Tactics in the United States, 1972–1988* (Bakersfield, Calif.: Charles Schlacks, 1988).

[34] Golam W. Choudhury, *China in World Affairs: The Foreign Policy of the PRC since 1970* (Boulder, Colo.: Westview Press, 1982).

[35] Miller (fn. 33).

[36] Harrison Wagner, "The Theory of Games and the Problem of International Cooperation," *American Political Science Review* 77 (1983), argues that games such as Harmony and Deadlock should be considered before any mixed-motive game. And in a game such as Deadlock, the very meaning of the term *cooperate* becomes questionable: if both sides prefer the defect-defect outcome, is this not mutual accommodation?

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And how can we interpret Goldstein and Freeman's finding of "limited reciprocity" in the relations between China and the U.S. in the 1970s and 1980s?[37] Goldstein and Freeman do not analyze Chinese and U.S. interaction in a game-theoretic context. By contrast our investigation of U.S-China relations begins with a game-theoretic model. But the incentive for cooperation depends on the structure of the game. Whether or not the U.S. and China can be described as playing a game of mixed motives is of paramount importance and must be addressed. If game theory is to have *empirical* relevance, the structure of payoffs must be identified if observed behavior is to be interpreted. The well-documented changes that occur in China-U.S. relations in 1972 and again in 1979 with the open-door policy provide us with an ideal test case of whether the data support a game-theoretic analysis of the facts.

III. The Formal Model

A First Formal Example

Let x_{us} represent the U.S. level of cooperation measured on a scale from 0 to 1. Here, 0 represents full cooperation while 1 represents full defection. Similarly $x_{ch} \in [0,1]$ represents China's level of cooperation. In this model, therefore, cooperation and defection are a question of degree. The [0,1] scale is, of course, arbitrary. In the empirical section, x_{us} and x_{ch} are levels of cooperation or defection as measured by coded WEIS data, using the same scale as Goldstein and Freeman.[38] *As a first example,* consider the linear payoff (for the U.S.)

$$U_{us}(x_{us},x_{ch}) = x_{us} - 2x_{ch}. \qquad (1a)$$

In this first example, we consider a typical Prisoner's Dilemma payoff for the United States. The success of countervailing strategies, as measured by their ability to promote a favorable outcome for both parties, depends on the payoff structure of the game. Games such as Harmony or Deadlock may require little strategic effort. But mixed-motive games do and often provide a fruitful environment for the pure countervailing approach.[39] Loosely speaking, success in establishing cooperation de-

[37] Goldstein and Freeman (fn. 24, 1990 and 1991).

[38] The data used by Goldstein and Freeman (fn. 24, 1990 and 1991) run on a scale from −6 to +6, where +6 represents full cooperation. In our notation, and if we did not aggregate events, this translates into $x_{us} = \frac{1}{2} - \frac{UC}{12}$, UC being the coded WEIS series representing U.S. behavior, and $x_{ch} = \frac{1}{2} - \frac{UC}{12}$, CU being the coded WEIS series representing Chinese behavior.

[39] Countervailing does not require a Prisoner's Dilemma structure in order to succeed. Indeed, our empirical estimates for the pre-open-door period (1972–78) point to a different game that, although

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pends on the relative magnitudes of the incentives to cooperate or defect. If we refer to "fear" as the loss of payoff resulting from the other side's unilateral defection and to "temptation" as the gain from one's own unilateral defection, it turns out that the reciprocity inherent in a countervailing strategy is favored if both parties' fears exceed their temptations. Returning to our linear payoff function for the U.S., temptation as defined above is the rate of change of the U.S. payoff with an increase in its defection level, while fear is the absolute value of the change in payoff suffered by the U.S. when China increases its level of defection. So, Temptation = $\frac{\partial U_{us}}{\partial x_{us}} = 1$, and Fear = $\left|\frac{\partial U_{us}}{\partial x_{ch}}\right| = 2$.

We define the Chinese payoff similarly as a linear function of both its own level of cooperativeness and that of the U.S. And *for the purposes of our simple example,* we assume the Chinese payoff to have the symmetric parameters:

$$U_{ch}(x_{ch},x_{us}) = x_{ch} - 2x_{us}. \tag{1b}$$

This game is a Prisoner's Dilemma defined on the unit square $[0,1] \times [0,1]$. In the repeated game the two sides simultaneously choose their level of cooperation/defection at each point in time t, thus determining an outcome $X^t = (x^t_{us},x^t_{ch})$ in the square. If the players are concerned with the future consequences of their decisions, a natural representation of how they value their relationship is the discounted payoff stream V_{us} (for the U.S., with discount factor ω_{us}, at time t):

$$V_{us}(t) = \sum_{s=0}^{\infty} \omega_{us}{}^{s} \times U_{us}(x^{t+s}_{us},x^{t+s}_{ch}). \tag{2}$$

In such a discounted repeated game, a strategy is a rule of play that determines each player's next move, given the prior history. So if the game begins at time t = 0 and is played periodically (at unit time intervals), $H^t = (X^0,X^1,\ldots,X^{t-1})$ is the history at time t, and each side bases its next decision on that history. Formally, we may write $x^t_{ch} = \psi_{ch}(H^t)$ to express China's move as a function of its strategy ψ_{ch} and, similarly, $x^t_{us} = \psi_{us}(H^t)$ for the U.S. However, assuming that a repeated game of

listed in exhaustive studies, has received little attention; see Steven J. Brams, *Theory of Moves* (Cambridge: Cambridge University Press, 1994). That game has a Nash equilibrium in which both sides defect, leaving one side (China) with its best outcome and the other (U.S.) with its next to worst. But countervailing succeeds in promoting a relatively cooperative outcome while providing an SGPE in that game.

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great power relations has a well-defined starting date, t = 0 is at best unconvincing. We therefore ignore any specific starting date and focus on strategies that are *stationary* in the length of past history that are taken into account in the next decision.[40] However, we make the standard assumption that players seek to maximize their discounted payoff stream, given their expectation of future behavior. *As a first example,* let us examine the implications of the following strategy for China:[41]

$$x^t_{ch} = \psi_{ch}(H^t) = \frac{1}{2\omega_{us}}\, x^{t-1}_{us}. \qquad (3a)$$

In this case the only relevant part of the past history in China's strategy would be the prior U.S. decision x^{t-1}_{us}. And as long as the discount factor ω_{us} is more than $\frac{1}{2}$, (3a) defines a true move x^t_{ch} (in the segment [0,1], for any move $x^{t-1}_{us} \in [0,1]$) and therefore describes a true strategy for China. Such a strategic choice by China consists in a dampened mirroring of the U.S. position and has remarkable implications *for the United States.* Plugging the Chinese response, as determined by (3a), into the U.S. objective (2) and using the explicit payoff (1a) yields by cancellation of matching terms

$$\begin{aligned} V_{us}(t) = {} & x^t_{us} - 2x^t_{ch} + \omega \times (x^{t+1}_{us} - 2x^{t+1}_{ch}) \\ & + \omega^2 \times (x^{t+2}_{us} - 2x^{t+2}_{ch}) + \ldots = -2x^t_{ch}. \end{aligned} \qquad (4)$$

This means that if China plays according to (3a), it is able to manipulate the value of the U.S. discounted payoff completely! It can do so *regardless of what the U.S. might play in response to the Chinese strategy at any given time.* It turns out that a whole class of strategies has as a consequence the full determination of the opponent's payoff. This class is made up of what we have referred to as *countervailing* strategies. The particular Chinese strategy described by (3a) is a countervailing strategy because it exactly compensates for any move by the U.S., so as to hold the U.S. to a particular discounted payoff that depends solely on the Chinese current position.[42] To see this, we will rewrite the U.S. payoff. By definition:

[40] When trying to define an initial date, the question is *how far back* one should consider past events and political regimes to be relevant to the day-to-day management of a relationship. By focusing on stationary strategies, we avoid this problem, although it is possible to reconstruct strategies that account for a starting date (see fn. 41).

[41] If an initial date t = 0 can be meaningfully defined, we need to describe x^0_{ch} separately. But as it turns out, an *arbitrary* x^0_{ch} will be optimal against the U.S. countervailing strategy we describe below.

[42] As the Chinese position x^t_{ch} evolves with time t, so does the U.S. discounted payoff in (4). Therefore, this Chinese countervailing strategy does not make the U.S. values *constant* in time. In fact, if the

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$$V_{us}(t) = U_{us}(x^t_{us}, x^t_{ch}) + \omega_{us} V_{us}(t+1). \quad (5a)$$

Given China's strategy as expressed by (3a), and according to (4), it is therefore the case that

$$-2x^t_{ch} = U_{us}(x^t_{us}, x^t_{ch}) - 2\omega_{us} x^{t+1}_{ch} \quad (5b)$$

or

$$-2x^t_{ch} = (x^t_{us} - 2x^t_{ch}) - 2\omega_{us} x^{t+1}_{ch}. \quad (5c)$$

Equation (5b) highlights that at time t+1 China will choose x^{t+1}_{ch} in order to counterbalance whatever move x^t_{us} is chosen by the U.S. at date t: If x^t_{us} is high, reflecting an aggressive U.S. stand, the U.S. payoff $U_{us}(x^t_{us}, x^t_{ch}) = (x^t_{us} - 2x^t_{ch})$, at time t, will be correspondingly high, given the choice x^t_{ch} that China makes before it can observe x^t_{us}. Conversely, a low x^t_{us} reflecting a U.S. cooperative stand yields a lower U.S. payoff $U_{us}(x^t_{us}, x^t_{ch})$, given the same x^t_{ch}. Since the left-hand side of (5b) is not influenced by the U.S. choice, it is x^{t+1}_{ch} that must counterbalance the U.S. payoff on the right-hand side of (5b). The move x^{t+1}_{ch} will thus retaliate in proportion to the magnitude of U.S. aggression and it will similarly reciprocate U.S. cooperative initiatives. It is because such moves are tailored to the gains or losses made in payoff that we call such strategies *countervailing*.

When the U.S. payoff is made explicit in (5c), the countervailing condition becomes an equation that directly relates China's next move to the current situation. In fact, (5c) is equivalent to (3a) after canceling the x^t_{ch} terms, solving for x^{t+1}_{ch}, and shifting the time index. This is a general fact that we will exploit in the next two sections to construct a class of countervailing strategies far vaster than (3a).

If both players play countervailing strategies, the resulting pair of strategies happens to form a subgame-perfect equilibrium (SGPE).[43] To see why countervailing strategies form SGPEs, it is enough to observe the following: if China plays countervailing toward the United States, all possible responses by the U.S. are equivalent to the U.S., since China actually determines the U.S. payoff. This means that one countervailing choice by the U.S. is as good as any other, whatever the his-

Chinese are provoked into higher and higher x^t_{ch}'s by a tough U.S. stand, the discounted values in (4) *decrease* as a result.

[43] Recall that this means that play prescribed by such strategies maximizes discounted payoff *regardless of the prior developments of the game.*

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tory of the game. If the U.S. also plays a countervailing strategy toward China, then the same reasoning applies to China. Countervailing strategies are therefore best responses to each other, whatever the past history of the game.

While providing an SGPE is an important check of rationality for strategies, equally important is the fact that countervailing strategies lead players to converge to a stable steady-state outcome, that is, a point in the outcome space $X^* = (x^*_{us}, x^*_{ch})$ that is stable given the strategies adopted by the players. In the terms of our example the steady-state outcome must satisfy for China:

$$x^*_{ch} = \frac{1}{2\omega_{us}} x^*_{us}. \tag{6a}$$

To find the steady-state outcome, it is, of course, necessary to specify the U.S. strategy. For the purposes of our example, assume that the U.S. plays the symmetric countervailing strategy:

$$x^t_{us} = \frac{1}{2\omega_{ch}} x^{t-1}_{ch}. \tag{3b}$$

At the steady state it must also be the case that

$$x^*_{us} = \frac{1}{2\omega_{ch}} x^*_{ch}. \tag{6b}$$

It follows that the steady-state outcome is $X^* = (x^*_{us}, x^*_{ch}) = (0,0)$, or full cooperation on both sides. That the steady state is a desirable outcome is important, but even more important is the fact that the strategies we define actually lead players to the steady state, provided both discount rates are strictly greater than $\frac{1}{2}$. Indeed, if we let $\rho = \frac{1}{2\omega_{us}} \times \frac{1}{2\omega_{ch}} < 1$, (3a) and (3b) result in (with t = 2s):

$$x^t_{ch} = \rho \times x^{t-2}_{ch} = \ldots = \rho^s \times x^{t-2s}_{ch} = \rho^s \times x^0_{ch}. \tag{7}$$

This shows that, starting from any $X^0 \in [0,1] \times [0,1]$, play as defined in our example will lead the players to full cooperation.

Of course, in response to (3a), the U.S. need not adopt the strategy (3b) or any other of the countervailing strategies we will study below. Indeed, since *any* U.S. strategy appears as good as (3b) at any point in time, due to the Chinese countervailing effect, why should the U.S. not adopt some other strategy? Although such a switch appears to have no

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effect on the day-to-day appraisal provided by the discounted payoff (4), another U.S. choice might, for instance, lead to a steady state X^* other than full cooperation, one that could benefit the U.S. unilaterally! In fact, this is impossible: any other steady-state X^* would still satisfy (6a) according to the Chinese strategy, and the U.S. steady-state payoff would still sum up to $-2x^*_{ch}$ by the countervailing effect. So a x^*_{us} higher than zero would provoke a x^*_{ch} correspondingly higher than zero, and a U.S. discounted steady-state payoff strictly less than the zero of full cooperation. If the U.S. were to adopt some other strategy, it had better ensure that it fully reciprocates cooperation, given the Chinese countervailing choice (3a).

We will now progressively generalize our example.

A First Generalization

In the numerical example of the preceding section, we specified a strategy for China that maintained the U.S. discounted payoff at specific levels that depended solely on China's moves. In order to specify the nature and consequences of countervailing strategies in a more general context, the introduction of more general notation is in order. Still denoting by ψ_{us} and ψ_{ch} the strategies adopted by the two players, and by $\Psi = (\psi_{us}, \psi_{ch})$ the resulting pair, the U.S. discounted sum of payoffs in (2) can be legitimately written $V_{us}(\Psi|H^t)$, in order to stress its dependence upon the strategic choices and the prior history of the game H^t. With this notation, recall that according to the definition of the discounted payoff

$$V_{us}(\Psi|H^t) = U_{us}(x^t_{us}, x^t_{ch}) + \omega_{us} V_{us}(\Psi|H^{t+1}). \tag{8}$$

What is special about the class of strategies that we call countervailing is that they define a discounted payoff for each player that *depends only on the opponent's current move* and the history of the game. Therefore, if China plays countervailing it will always be the case that

$$V_{us}(\Psi|H^t) \equiv g_{us}(x^t_{ch}|H^t) \tag{9}$$

for some function g_{us} that will be further specified below. For instance, if the countervailing strategies under consideration specify moves that depend on the previous position only, excluding any history prior to that, then the U.S. discounted payoff depends exclusively on the current Chinese move and

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$$V_{us}(\psi|H^t) \equiv g_{us}(x^t_{ch}) = U_{us}(x^t_{us}, x^t_{ch}) + \omega_{us} g_{us}(x^{t+1}_{ch}). \tag{10}$$

Rather than define a countervailing strategy directly, as we did in the above numerical example, we will now focus on both the particular form that can be given to the function g_{us} that results from countervailing play by China and the consequences of this choice for strategy. In our example we chose a strategy for China that determined the following g_{us} for the United States:

$$g_{us}(x^t_{ch}) = -2x^t_{ch}. \tag{11}$$

Consider the following, slightly more general g_{us}:

$$g_{us}(x^t_{ch}) = -\gamma_{ch} x^t_{ch} \tag{12}$$

where $\gamma_{ch} > 0$ is a parameter that will characterize the Chinese strategy. Keeping linear payoffs as in the example of the preceding section but generalizing these payoff structures to allow differences between the two countries we can write[44]

$$\begin{aligned} U_{us}(x_{us}, x_{ch}) &= x_{us} - b_{us} x_{ch} \\ U_{ch}(x_{ch}, x_{us}) &= x_{ch} - b_{ch} x_{us}. \end{aligned} \tag{13}$$

Applying the equality spelled out in (10) yields for the U.S.:

$$-\gamma_{us} x^t_{ch} = x^t_{us} - b_{us} x^t_{ch} - \gamma_{ch} \omega_{us} x^{t+1}_{ch} \tag{14a}$$

or

$$x^{t+1}_{ch} = \frac{1}{\gamma_{ch} \omega_{us}} x^t_{us} + \frac{\gamma_{ch} - b_{us}}{\gamma_{ch} \omega_{us}} x^t_{ch}. \tag{14b}$$

Equality (14b) makes explicit China's countervailing strategy by expressing its move at date t + 1 as a function of the previous position X^t.[45] Interestingly, China's move will depend on its own previous position x^t_{ch} and will therefore exhibit policy inertia as measured by the parameter $\frac{\gamma_{ch} - b_{us}}{\gamma_{ch} \omega_{us}}$. But China's strategy will also exhibit some degree

[44] Since we wish to discuss the Prisoner's Dilemma structure in this section, we must assume $b_{ch} > 0$ and $b_{us} > 0$. But it is possible to relax this restriction and to consider Deadlock-type games.

[45] In this approach, where the strategy is derived from the countervailing assumptions (9) and (12), we express x^{t+1}_{ch} as a function of X^t instead of x^t_{ch} as a function of X^{t-1} as in (3a). Of course, the two approaches are equivalent.

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of reciprocity, since we assumed $\gamma_{ch} > 0$. Indeed, the Chinese will respond to the U.S. through a partial mirroring of the previous U.S. move. Thus a cooperative initiative on the part of the U.S. is reciprocated in part, but an aggressive move by the U.S. will elicit a lessening of cooperation or a strengthening of China's aggressiveness.

Of course, some restrictions on γ_{us} are necessary for (14b) to express a true strategy, that is, a rule that defines a *true* move in the decision space [0,1]. Here, assuming that X^t is in the unit square, x_{ch}^{t+1} is in [0,1] provided that

$$b_{us} \leq \gamma_{ch} \leq \frac{b_{us} - 1}{1 - \omega_{us}}. \tag{15}$$

For this condition on γ_{ch} to be realized, we must require $b_{us} > \frac{1}{\omega_{us}}$ so that (15) defines a nonempty range of countervailing strategies. In the payoff (13), where temptation has been normalized to 1, this means that *fear must outweigh temptation* for countervailing strategies to exist in a Prisoner's Dilemma.[46] Intuitively, when this condition fails, the temptation to defect overwhelms any attempt at stabilizing the game by a countervailing opponent. But when fear outweighs temptation, since the strategy defined in (14b) is countervailing, it forms an SGPE together with *any* similarly defined strategy by the United States. Moreover, if the inequalities in (15) are strict, one can show as in (7) that play according to this strategy pair converges to the full cooperative steady state (0,0).[47]

If China and the U.S. were to adopt such countervailing strategies and their payoffs could be safely approximated by linear functions, then we would seek in the data estimates of γ_{ch} and similarly defined γ_{us}, the parameters characteristic of each player's strategic behavior, as well as b_{us} and symmetrically defined b_{ch} to characterize the payoff structure of each of the players. But it is likely that true strategic interaction will take into account a number of past moves, by oneself and by one's opponent, in determining the appropriate next step. Thus we will introduce a final generalization that will be the model for our empirical estimates.

[46] Again we emphasize that payoff structures other than the Prisoner's Dilemma can be successfully dealt with using our countervailing approach. In other game structures the fear and temptation concepts do not necessarily apply and other relationships emerge.

[47] All other remarks made about the robustness of the countervailing strategy (3a) extend to (14b). In particular, no U.S. strategy could promote a better steady state for the U.S.

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The Model to Be Estimated

In the examples we have considered thus far, the strategies specify moves that depend only on the immediate past. We now want to build in a dependence on several past positions in order to capture possible decision lags that can differ from country to country, as well as a response that develops gradually over several periods. To examine such strategies we will proceed as we did in the example of the preceding section, first defining the level of discounted payoff to which each side holds its opponent, and from that inferring the particular strategic choice. Our previous example started with a function g_{us}, characteristic of China's countervailing strategy, that had the form $g_{us}(x^t_{ch}) = -\gamma_{ch}x^t_{ch}$. We now consider the more general function:

$$\begin{aligned} g_{us}(x^t_{ch}|H^t) &= g_{us}(x^t_{ch}, X^{t-1}, X^{t-2}, \ldots, X^{t-n}) \\ &= -\gamma_{ch}x^t_{ch}ch - \alpha^1_{ch}x^{t-1}_{us} - \beta^1_{ch}x^{t-1}_{ch} - \ldots \\ &\quad - \alpha^n_{ch}x^{t-n}_{us} - \beta^n_{ch}x^{t-n}_{ch} - k_{ch} \end{aligned} \tag{16}$$

where k_{ch}, the alphas, and the betas are parameters of arbitrary sign.[48] If China's strategy can achieve a countervailing effect as specified in (16), it must be the case that

$$\begin{aligned} &g_{us}(x^t_{ch}, X^{t-1}, X^{t-2}, \ldots, X^{t-n}) \\ &= x^t_{us} - b_{us}x^t_{ch} + \omega_{us}g_{us}(x^{t+1}_{ch}, X^t, X^{t-1}, \ldots, X^{t-n+1}). \end{aligned} \tag{17}$$

Combining (16) and (17), China's move of t+1 can be expressed as a function of past moves:[49]

$$\begin{aligned} \omega_{us}\gamma_{ch}x^{t+1}_{ch} &= (1 - \omega_{us}\alpha^1_{ch})x^t_{us} + (\gamma_{ch} - b_{us} - \omega_{us}\beta^1_{ch})x^t_{ch} \\ &\quad + (\alpha^1_{ch} - \omega_{us}\alpha^2_{ch})x^{t-1}_{us} + (\beta^1_{ch} - \omega_{us}\beta^2_{ch})x^{t-1}_{ch} \\ &\quad \cdots \\ &\quad + (\alpha^{n-1}_{ch} - \omega_{us}\alpha^n_{ch})x^{t-n+1}_{us} + (\beta^{n-1}_{ch} - \omega_{us}\beta^n_{ch})x^{t-n+1}_{ch} \\ &\quad + \alpha^n_{ch}x^{t-n}_{us} + \beta^n_{ch}x^{t-n}_{ch} + (1 - \omega_{us})k_{ch}. \end{aligned} \tag{18}$$

Before we turn to the statistical estimations, a few words must be said about the rationality of the kind of strategy described by relation-

[48] g_{us} could also be written as a sum. The particular form chosen is for notational convenience when writing out China's move at time (t + 1) as a function of the past history of play.

[49] We could have generalized the payoff function and the g_{us} and g_{ch} functions to include terms in $x_{us}x_{ch}$. Such cross terms allow for estimation of a wider variety of payoff functions. However, the inferred coefficient on the cross term for the payoff functions were not found to be significantly different from zero.

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ship (18). First, it must be the case that (18) *actually defines* a strategy. In other words China's move x_{ch}^{t+1}, at time t + 1, must belong to the interval specified in the model. Although we used the unit interval [0,1] in the previous sections, it is entirely possible to use the range [−6,6] of the WEIS data. However, since +6 means the most cooperative attitude in WEIS, it is necessary to interpret x_{ch} as − CU (the score attributed to a Chinese move toward the U.S.), and x_{us} as − UC, in order to fit the payoff function (13). Then, the move x_{ch}^{t+1} specified by (18) is within the extended range [−6,6] provided that[50]

$$|1 - \omega_{us}\alpha_{ch}^{1}| + |\gamma_{ch} - b_{us} - \omega_{us}\beta_{ch}^{1}| + \sum_{i=1}^{n-1} |\alpha_{ch}^{i} - \omega_{us}\alpha_{ch}^{i+1}| + \sum_{i=1}^{n-1} |\beta_{ch}^{i} - \omega_{us}\beta_{ch}^{i+1}| + |\alpha_{ch}^{n}| + |\beta_{ch}^{t}| + (1 - \omega_{us})|k_{ch}| \div 6 \leq \omega_{us}\gamma_{ch}. \quad (19)$$

If (19) holds, (18) does define a strategy, and if the U.S. behaves similarly, then the strategy pair forms a SGPE since each side is countervailing the other. In fact, if the inequality in (19) is strict, it is also possible to infer the existence of a *dynamically stable* steady state whose position depends on the value of the constant k_{ch}.

What is remarkable about relationship (18) is that the parameters of China's strategy as well as the U.S. payoff parameter b_{us} are identifiable and can be inferred by a vector autoregression.[51] As outlined in Appendix 1, the estimated coefficients of the x_{us}^{t-s} terms allow for an inductive calculation of the α_{ch}^{s}'s and γ_{ch} (with appropriate confidence intervals). Then, the estimated coefficients of the x_{ch}^{t-s} terms yield inductively the β_{ch}^{s}'s and b_{us}. If both estimated b_{us} and b_{ch} are greater than 1, the game is a Prisoner's Dilemma; and the higher their magnitudes, the greater the players' incentives to establish tacit cooperation. If both coefficients turn out to be positive, but less than 1, the game is a Deadlock type. And when both coefficients fall into the negative, defection provides both the best individual and the best collective outcome.[52] But the case

[50] The denominator 6 in the k-term accounts for the range. The use of monthly data leads to aggregation of events and a widening of the range of the data. This would magnify the denominator 6 and would not affect the rest of our analysis. Of course, we still need to assume *some bounded* interval to guarantee the boundedness of payoffs required by the theorem in Appendix 2.

[51] An autoregression following (18) will identify the parameters of a countervailing strategy. As the main theorem in Appendix 2 demonstrates, strategies that form SGPEs are either countervailing or coordinated. If the players do not adopt a countervailing strategy but instead coordinate play, then the data should reveal punishing responses by each player. As mentioned above, we provide, in Appendix 3, a test of the hypothesis that China and the U.S. could be coordinating their moves rather than implementing countervailing strategies. The data do not support the hypothesis of coordination.

[52] In that case, countervailing would not succeed in providing an SGPE. A finding of negative b-coefficients for both sides would therefore refute the countervailing hypothesis.

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where one side has a b-coefficient that is greater than one and the other has a negative b-coefficient provides an unusual and interesting situation that does not appear to have received much attention in the literature. Since that game appears as the outcome of the empirical study in the period 1972–78, we will discuss it more extensively in a concluding section.

IV. The Empirical Estimates

Data and Methodology

To estimate the parameters of relationship (18) for the U.S. and for China, we used coded monthly WEIS data, since that database extends through the 1980s, a period of critical importance for our purposes. The data were coded according to the Vincent scale, as in Goldstein and Freeman.[53] This scale has been criticized and improved,[54] but the improved scaling system did not alter the substantive results obtained with the Vincent scale to code the data. That events data are noisy is a well-known fact. We will therefore expect relatively low R-squared coefficients on our estimations. Furthermore, the ω-parameters that appear in the definition of the discounted objective (2) are not identifiable. However, it is standard practice to give them an arbitrary value such as $\omega_{us} = \omega_{ch} = 0.95$. In fact, setting ω-parameters within a realistic range (from about 0.9 to 1.0) consistently yields the same regression results.

Our empirical methodology entails estimating a full vector autoregression for each country and then trimming that regression by eliminating those right-hand side variables that do not contribute to the regression according to the Akaike information criterion. Before estimating the VAR, we needed to choose the maximum lag length. This is necessarily a somewhat arbitrary process, since, even if blocks of lags do not appear to have explanatory power when conducting a Granger causality test, it could be the case that lags from the more distant past are *individually* significant in a regression. Thus we somewhat arbitrarily considered a maximum lag of six months in all our regressions. This means that we assume China and the U.S. do not spread the response to any single move over more than six months, and that it does not take either of these states more than six months to respond to a cooperative

[53] Jack E. Vincent, *Project Theory* (Landam: University Press of America, 1979); Goldstein and Freeman (fn. 24, 1990).

[54] Joshua S. Goldstein, "A Conflict-Cooperation Scale for WEIS Events Data," *Journal of Conflict Resolution* 36, no. 2 (1992).

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initiative or an act of aggression.[55] Such a maximum for the lagged variables on the right-hand side is consistent with the lag structure used in full-fledged VARs by Goldstein and Freeman.

Once our VARs are trimmed of statistically insignificant variables, the equations for each country end up having different variables on the right-hand side. It is therefore no longer appropriate to estimate these relations separately using ordinary least squares. Instead they must be estimated as a system using seemingly unrelated regression in order to ensure that the coefficients are unbiased.[56] Finally, since the time series we use are stationary, we can associate them without running the risk of spurious regression.[57] We now turn to the regression results.

The Regression Results

We divided our data set into two samples: 1972 to 1978 and 1979 to 1988. This partitioning is motivated by historical events, with 1972 marked by Nixon's visit to China and 1979 by the beginning of the open-door policy.[58] Estimation of relationship (18) for each country yielded strikingly different results across samples. The first set of equations reproduced below was estimated using data running from March 1972 to December 1978; standard errors are in parentheses:

$$\underset{}{x_{ch}^{t+1}} = \underset{}{2.07} - \underset{(.10)}{.26\, x_{ch}^{t-1}} + \underset{(.08)}{.12\, x_{ch}^{t-4}} + \underset{(.12)}{.33\, x_{us}^{t-3}} \quad \underset{(.49)}{}$$

$$x_{us}^{t+1} = \underset{(.09)}{.32\, x_{us}^{t-1}} - \underset{(.08)}{.17\, x_{ch}^{t-1}} - \underset{(.07)}{.17\, x_{ch}^{t-2}} - \underset{(.07)}{.14\, x_{ch}^{t-4}} + \underset{(.066)}{.099\, x_{ch}^{t-5}} \qquad (20)$$

Estimates for the values of the b-coefficients (b_{us} and b_{ch}) in the payoff function (13) can be identified by induction on the estimated coefficients of system (20). Calculations are described in Appendix 1. For the U.S., we find[59]

[55] Such a restriction does not imply that the effects of an aggressive move will necessarily evaporate after six months. First, if the defector persists in an aggressive position, countervailing will continue and even deepen with time. And if the defector moves back to cooperation, the countervailing responses will only slowly reestablish cooperation.

[56] See William Greene, *Econometric Analysis* (New York: Macmillan, 1993).

[57] See Clive Granger and Paul Newbold, "Spurious Regressions in Econometrics," *Journal of Econometrics* 2 (1974).

[58] It turns out that when the equations estimated for the period 1972 to 1978 are used to explain subsequent years, a break in the data is apparent about 1979 and is confirmed by a formal Chow test.

[59] Even under the standard assumption of normal distribution for the coefficients estimated in (20), the resulting distribution of the b-coefficients is not normal since their derivation involves nonlinear transformations.

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$\hat{b}_{us} = 4.23$ and $b_{us} \geq 1$ with 98 percent confidence.

Therefore, the United States payoff is characteristic of the Prisoner's Dilemma in its interaction with China during the 1970s.

Interestingly, our estimate for b_{ch} is *negative*. This means that China's payoff *increases* with U.S. defection. We find

$\hat{b}_{ch} = -2.11$ and $b_{ch} \leq -1$ with 99 percent confidence.

Nevertheless, countervailing strategies are appropriate courses of action for each player in this case, and they lead to a steady-state outcome. We will expand on this below. The steady state for the 1970s is about

$$x^*_{ch} = 1.56 \text{ and } x^*_{us} = -0.87 \tag{21}$$

showing steadier cooperation on the U.S. side than on the Chinese side.

Our estimates for the period running from January 1979 to December 1988 are as follows:

$$\begin{aligned} x^{t+1}_{ch} &= \underset{(.44)}{1.24} + \underset{(.08)}{.19}\, x^{t-1}_{ch} + \underset{(.08)}{.19}\, x^{t-3}_{us} \\ x^{t+1}_{us} &= \underset{(.45)}{-1.81} + \underset{(.09)}{.17}\, x^{t-2}_{ch}. \end{aligned} \tag{22}$$

In contrast to the pre-open-door estimates presented above, estimates for b_{us}, and b_{ch} reveal a Prisoner's Dilemma. For the U.S.

$\hat{b}_{us} = 5.42$ and $b_{us} \geq 1$ with 98 percent confidence

and for China

$\hat{b}_{ch} = 6.78$ and $b_{ch} \geq 1$ with 95 percent confidence.

The strategies adopted by each country now lead to a dynamically stable steady state

$$x^*_{ch} \simeq 0.0010 \text{ and } x^*_{us} \simeq -0.0015 \tag{23}$$

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showing a softening of the Chinese attitude and a lessening of U.S. cooperation.

Interpreting the Results

The expected payoff structure found in the period 1972–78 is

$$U_{us} = x_{us} - 4.23x_{ch}$$
$$U_{ch} = x_{ch} + 2.11x_{us}. \qquad (24)$$

Such a payoff structure may reflect the internal political strife in China in the mid-1970s. As Miller points out, Chou En-Lai's declining health and death in 1976 enabled his opponents to discredit his initiatives.[60] Rhetoric from the People's Republic of China in the mid-1970s "attacked the U.S. superpower hegemony and imperialist exploitation" and such action could indeed mean political gain to signs of defection on the part of the United States. On the U.S. side, however, a more pragmatic attitude and an awareness of the economic implications of a Chinese opening lead to a positive valuation of Chinese cooperation.

In the one-shot game defined by (24), both sides benefit from unilateral defection. However, although Defect-Defect appears to be the (possibly ideologically motivated) favorite outcome for the Chinese, it is not so for the U.S. Symmetric moves toward cooperation would considerably improve the U.S. lot. In fact, on the scale [−6,6] that underlies the empirical findings, China's steady-state level of about 1.56 is not as uncooperative as one could fear. By contrast, the U.S. steady-state level of about −0.87 is rather accommodating. But a closer look at the U.S. strategy holds some explanation: in (20) the U.S. response exhibits policy inertia (with factor 0.32) and mirrors the Chinese stand with a predominantly *negative* coefficient (of about −0.38 overall). This means that the U.S. responds cooperatively to Chinese defection and uncooperatively to Chinese cooperation! The effect of this U.S. strategy on China's steady-state payoff is most interesting: given any strategy ψ_{ch} for China, whatever steady state (not necessarily unique) X^* may result must satisfy, according to the second line of (20):

$$x^*_{us} = .32\, x^*_{us} - .17\, x^*_{ch} - .17\, x^*_{ch} - .14\, x^*_{ch} + .099\, x^*_{ch}$$

or: $$x^*_{us} \simeq -0.56\, x^*_{ch} \qquad (25)$$

so that: $U_{ch}(X^*) = (1 - 2.11 \times 0.56)x^*_{ch} = -0.18\, x^*_{ch}$.

[60] Miller (fn. 33).

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So China's steady-state payoff *increases* with China's cooperation in response to the U.S. strategy! Of course, it is China's own strategy choice, which, by providing a second steady-state equation similar to (25), finally settles a steady-state position. Since any two countervailing strategies form an SGPE (according to the theorem in Appendix 2), China's problem is only to find one that will promote the best steady state for itself. This would suggest looking for one that makes x^*_{ch} as small as possible, possibly equal to −6. However, a true countervailing strategy for China is incompatible with a steady state on or near the edge of its action space. Not surprisingly, the countervailing requirement restricts the region of possible steady states, just like any other SGPE concept does.

Apart from the above countervailing argument, a U.S. strategy that responds cooperatively to Chinese defection and uncooperatively to Chinese cooperation appears as a very rational choice in this game structure. To see this, consider the 2 × 2 matrix game of Figure 1 which has the same preference structure as that defined by (24).

The Nash equilibrium here is Defect-Defect. But if the U.S. could somehow *commit* to move (up) from DD to CD and (down) from CC to DC, the Chinese would find it in their best interest to move (left) from CD to CC, while attempting to remain at DD. Interestingly, this is precisely what Brams's Theory of Moves predicts in this game (called #35 in his nomenclature).[61] The outcome DC, which substantially improves the lot of the U.S., is what Brams calls a Non-Myopic Equilibrium in his theory, and it is achieved by what he would call here the U.S.'s "Moving Power." The countervailing approach is, of course, different. But it makes the above "commitment" an implicit and totally credible part of U.S. strategy.

As the 1970s drew to a close, the benefits of normalized relations with the U.S. took on more and more prominence until, finally, diplomatic relations were established, and China was given most favored nation status in early 1979. The game then turned into a typical Prisoner's Dilemma and resulted in a more symmetrical behavior. In (21), the United States now exhibits reactive behavior with a *positive* factor (0.17) and has no significant policy inertia, possibly indicating more flexibility toward China. The resulting steady state brings China to a more cooperative stance in the 1980s, while the U.S., still cooperative, slightly hardens its position relative to its posture for the 1970s. Over-

[61] Brams (fn. 39).

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	China cooperates	China defects
U.S. cooperates	CC [3,1] (19.38,−18.66)	CD [1,2] (−31.38,−6.66)
U.S. defects	DC [4,3] (31.38,6.66)	DD [2,4] (−19.38,18.66)

FIGURE 1
THE U.S.-CHINA GAME[a]
(1972–78)

[a] Payoffs using (24) are in parentheses; ordinal utilities are in square brackets (from least preferred = 1 to most preferred = 4); DD is a Nash equilibrium; and DC is a Non-myopic equilibrium.

all, the outcome is mildly cooperative, a finding in line with that of Goldstein and Freeman.[62]

V. CONCLUSION

This paper develops a model of rational behavior that is found to be compatible with the evolution of China-U.S. relations from the early 1970s to the late 1980s. Our work is most closely related to that of Goldstein and Freeman and Goldstein.[63] In contrast to these authors, we work with a game-theoretic model that highlights a class of rational behavior that we call "countervailing" and that is found to be involved in any equilibrium strategy. Countervailing behavior broadens the scope of what was believed to be rational in a game-theoretic context, accommodating inertia, delays, and reactivity, and allowing for reciprocity in the face of a cooperative initiative and for measured retaliation in response to aggression. The terms of a countervailing strategy can be traced in the coefficients of a vector autoregression, and we find that the data on U.S.-China relations are compatible with rational behavior on both sides. Interestingly, the nature of these rational re-

[62] Goldstein and Freeman (fn. 24, 1990 and 1991).
[63] Goldstein and Freeman (fn. 21, 1991); and Goldstein (fn. 27, 1994).

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sponses is found to change at a critical point in the history we examine. Indeed, once the terms of the strategic interaction between the U.S. and China have been identified, we are able to infer the payoffs that support the observed dynamic interaction. This is a new and critical step, since the identification of the payoff structure allows for proper interpretation of observed behavior. We find a break point in the data in 1979, when China opens its doors to the development of economic relations with the West. We also find that the payoff structure we infer for the period prior to 1979 conforms to a little-known mixed-motive game while the 1980s are characterized by the Prisoner's Dilemma. In the 1980s rational play finds expression in positive reactivity on the part of each country, while prior to 1979 rational behavior on the part of the U.S. takes the form of an inverse response to Chinese initiatives, a behavior that draws its rationality from its ability to move China to a more cooperative stance despite its Deadlock-type payoff structure.

Appendix 1: Inferring Game Parameters from Estimated Reactions

The empirical estimation in (20) can be written

$$x_{ch}^{t+1} = a_{ch}^{0}x_{us}^{t} + a_{ch}^{1}x_{us}^{t-1} + ..+ a_{ch}^{n}x_{us}^{t-n} + b_{ch}^{0}x_{ch}^{t} + b_{ch}^{1}x_{ch}^{t-1} + ..+ b_{ch}^{n}x_{ch}^{t-n} + c_{ch} \quad (26)$$

where the a_{ch}^{k} and b_{ch}^{k} (for k = 0, . . , n) are estimated statistically. But, by (18), if the countervailing model is believed, the following relationships hold:

$$\frac{\alpha_{ch}^{n}}{\omega_{us}\gamma_{ch}} = a_{ch}^{n} \text{ and, by backward induction (for k = 1, . . , n):}$$

$$\frac{\alpha_{ch}^{k}}{\omega_{us}\gamma_{ch}} = a_{ch}^{k} + \omega_{us}a_{ch}^{k+1} + ..+ \omega_{us}^{n-k}a_{ch}^{n} \text{ and, at k = 0:}$$

$$\frac{1}{\omega_{us}\gamma_{ch}} = a_{ch}^{0} + \omega_{us}a_{ch}^{1} + ..+ \omega_{us}^{n}a_{ch}^{n}. \quad (27)$$

So, if we let $A_{ch} = \sum_{k=0}^{n} \omega_{us}^{k+1}a_{ch}^{k}$, we may write $\gamma_{ch} = 1 \div A_{ch}$. A similar induction on the β_{ch}^{k} and b_{ch}^{k} coefficients, with the notation $B_{ch} = \sum_{k=0}^{n} \omega_{us}^{k+1}b_{ch}^{k}$, yields the important formula

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$$b_{us} = (1 - B_{ch}) \div A_{ch} \tag{28}$$

and similarly for b_{ch}. Formula (28) can now be exploited to infer an expected value. It can also be used to obtain confidence intervals for b_{us} from the covariance matrix of the a_{ch}^k and b_{ch}^k coefficients. For instance, $b_{us} \geq 1$ is equivalent to the condition

$$\begin{aligned}&\{(A_{ch} > 0) \text{ and } (A_{ch} + B_{ch} \leq 1)\} \text{ or}\\ &\{(A_{ch} < 0) \text{ and } (A_{ch} + B_{ch} \geq 1)\}.\end{aligned} \tag{29}$$

Furthermore, $\text{var}(A_{ch}) = J\Sigma J^T$, where Σ is the covariance matrix of the estimated coefficients and J is the (row) vector of the partial derivatives $\partial A_{chs}/\partial a_{ch}^k = \omega_{us}{}^{k+1}$. Using (29), we may write

$$\begin{aligned}&\text{proba}(b_{us} \geq 1) \geq \text{proba}(A_{ch} > 0)\\ &+ \text{proba}(A_{ch} + B_{ch} \leq 1) - 1\end{aligned} \tag{30}$$

and use the appropriate t-values on a one-tail test.

For instance, in our post-open-door estimates for b_{us}: $(\sigma_{A_{ch}})^2 = \text{var}(A_{ch}) = \omega_{us}{}^8(\sigma_{a_{ch}^2})^2 \simeq (0.95)^8(0.0768)^2 \simeq 0.00391$. Similarly, $(\sigma_{A_{ch}+B_{ch}})^2 = \text{var}(A_{ch} + B_{ch}) \simeq 0.0529$. Since we find means $\tilde{A}_{ch} \simeq 0.153$, and $\tilde{A}_{ch} + \tilde{B}_{ch} \simeq 0.323$, using the above standard deviations, $\tilde{A}_{ch} - k\sigma_{A_{ch}} > 0$ implies $k \simeq 2.4$, and $\tilde{A}_{ch} + \tilde{B}_{ch} + k\sigma_{A_{ch}+B_{ch}} \leq 1$ implies $k \simeq 2.94$. Using (30), probability $(b_{us} \geq 1) \geq 0.98$.

Appendix 2: A Characterization of SGPEs in Discounted Supergames

The following result provides a fairly general characterization of SGPEs in discounted repeated games. It is stated for two players and no state variable other than the players choices and prior history, but it can be generalized to finitely many players and stochastic games. For each player i, it highlights two functions g_i and π_i that will be interpreted below in terms of the countervailing and expectation effects that characterize SGPE strategies.

Theorem: In a discounted repeated game with bounded payoffs,[64] a

[64] This is the case when payoffs are continuous and defined over a compact decision space. Here, for instance, the linear payoffs (13) are continuous and the decision space $[0,1] \times [0,1]$ is compact (as closed and bounded in $\Re^2$).

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strategy pair $\Psi = (\psi_i, \psi_j)$ is an SGPE if and only if there exist two real valued and bounded functions g_i and two nonnegative and bounded functions π_i such that for any decision pair X^t, and any prior history $H^t = \{X^0, X^1, .., X^{t-1}\}$ at any time $t \geq 0$, Ψ satisfies for i = 1,2:[65]

$$\begin{cases} g_i(x_j^t | H^t) - \pi_i(X^t | H^t) = U_i(X^t) + \omega_i g_i(\psi_j(H^{t+1}) | H^{t+1}) \\ \pi_i(\Psi(H^t) | H^t) = 0 \quad \text{with the notation } H^{t+1} = \{H^t, X^t\}. \end{cases} \tag{31}$$

Proof: First assume that Ψ is an SGPE. Then, for i = 1,2, any pair X^t, and any history H^t, let

$$\gamma_i(X^t | H^t) = \sum_{s=0}^{\infty} \omega_i^s U_i(X^{t+s})$$

$$\text{with} \quad H^{t+s+1} = \{H^{t+s}, X^{t+s}\} \text{ for all } s \geq 0$$

$$\text{and} \quad X^{t+s} = \Psi(H^{t+s}) \text{ for all } s \geq 1. \tag{32}$$

Clearly, γ_i is bounded since U_i is. So, we may define the bounded functions:

$$g_i(x_j^t | H^t) = \underset{x_i^t}{\text{supremum}}\ \gamma_i((x_i^t, x_j^t) | H^t)$$

$$\text{and} \quad \pi_i(X^t | H^t) = g_i(x_j^t | H^t) - \gamma_i(X^t | H^t) \geq 0. \tag{33}$$

We may rewrite, by definition of the discounted objective (32):

$$\gamma_i(X^t | H^t) = U_i(X^t) + \omega_i \gamma_i(X^{t+1} = \Psi(H^{t+1}) | H^{t+1}). \tag{34}$$

However, since Ψ is assumed to be an SGPE, $\psi_i(H^{t+1})$ is a *maximizand* with respect to x_i^{t+1} of $\gamma_i(x_i^{t+1}, \psi_j(H^{t+1}) | H^{t+1})$. Therefore $\gamma_i(\Psi(H^{t+1}) | H^{t+1}) = g_i(\psi_j(H^{t+1}) | H^{t+1})$, and $\pi_i(\Psi(H^{t+1}) | H^{t+1}) = 0$. Replacing this in (34), together with $\gamma_i(X^t | H^t)$ according to the second line of (33), yields (31).[66]

Conversely, if Ψ satisfies (31) for all X^t, H^t, and i = 1,2, with bounded g_i and π_i as described, let us consider (32) again. If we *further* assume that $X^{t+s} = \Psi(H^{t+s})$ for all $s \geq 0$, then, by assumption (31), using the notations (32), since all $\pi_i(X^{t+s} | H^{t+s}) = 0$, by the second line of (31):

[65] At time t = 0, $H^0 = \emptyset$. Also note that the history H^t is of length t and that no *stationarity* assumption is necessary for either the strategies or the g_i and π_i functions.

[66] Since H^t is as arbitrary as H^{t+1}, we may use either one in the equality of the second line of (31).

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$$\begin{aligned} g_i(x_j^t|H^t) &= U_i(X^t) + \omega_i g_i(\psi_j(H^t) = x_j^{t+1}|H^{t+1}) \\ &= U_i(X^t) + \omega_i\{U_i(X^{t+1}) + \omega_i\{ \ldots + \omega_i\{U_i(X^{t+s}) + \\ &\quad \omega_i g_i(x_j^{t+s+1}|H^{t+s+1})\}\ldots\}\} \\ &= \sum_{s=0}^{\infty} \omega_i^s U_i(X^{t+s}). \end{aligned} \tag{35}$$

Now, consider an arbitrary strategy ϕ_i for Player i (instead of ψ_i), and let $\Phi = (\phi_i, \psi_j)$. We also assume play according to Φ from an arbitrary H^t at an arbitrary time $t \geq 0$. We let $G^t = H^t$, and denote for all $s \geq 0$: $Y^{t+s} = \Phi(G^{t+s})$ and $G^{t+s+1} = \{G^{t+s}, Y^{t+s}\}$. Clearly $y_j^t = x_j^t$, and since ψ_j satisfies the first line of (31) independently of the choice ϕ_i, by boundedness of g_i and π_i we have

$$\begin{aligned} g_i(x_j^t|H^t) &= g_i(y_j^t|G^t) \geq U_i(Y^t) + \omega_i g_i(y_j^{t+1}|G^{t+1}) \\ &\geq U_i(Y^t) = \omega_i\{U_i(Y^{t+1}) + \omega_i g_i(y_j^{t+2}|G^{t+2})\} \geq \ldots \\ &\geq U_i(Y^t) + \omega_i\{U_i(Y^{t+1}) + \ldots + \omega_i\{U_i(Y^{t+s}) \\ &\quad + \omega_i g_i(y_j^{t+s+1}|G^{t+s+1})\}\ldots\} \\ &\geq \sum_{s=0}^{\infty} \omega_i^s U_i(Y^{t+s}). \end{aligned} \tag{36}$$

Moreover, at least one of these inequalities is strict if at any point $\pi_i(Y^{t+s}|G^{t+s}) > 0$. This shows that (35) is greater that (36) for any ϕ_i and that it is strictly so if, at any point, Φ fails to make $\pi_i = 0$. So, ψ_i is the best that Player i can do in response to ψ_j given the arbitrary H^t. Since this holds for i = 1,2, Ψ is an SGPE. *Q.E.D.*

APPENDIX 3: INTERPRETATION

The most interesting aspect of the first line of (31) is that, although it concerns i's payoffs, it can be viewed as a condition on i's opponent's strategy ψ_j. In order to decipher that condition, we will proceed in two parts.

First, let us assume that the two players play according to a strategy pair Ψ such that $\pi_i \equiv 0$. Player i's successive discounted payoff streams are then given by g_i, as in (35), and evolve according to

$$g_i(\psi_j(H^t)|H^t) = U_i(X^t) + \omega_i g_i(\psi_j(H^{t+1})|H^{t+1}). \tag{37}$$

This is what we call the countervailing effect of ψ_j on i's successive payoff streams: given the current history H^t, the left-hand side of (37) is

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fully determined by g_i and ψ_j, and whatever i may gain or lose in the contemporary payoff $U_i(X^t)$, depending on what x_i^t he chooses, will be exactly compensated for in tomorrow's value of g_i. For instance, if g_i is a decreasing function of its argument ψ_j and is independent from its other argument H^t, an increase in U_i due to a variation of x_i^t requires a commensurate increase in $\psi_j(H^{t+1})$ so that the value of the left-hand side of (37) remains unchanged. Note that nothing specific is said here about whether i plays according to ψ_i.

However, and this is the second part, the function π_i need not satisfy the condition $\pi_i \equiv 0$. If it does not, then a deviation x_i^t from $\psi_i(H^t)$, while j plays $\psi_j(H^t)$, may entail a positive $\pi_i(x^t{}_i, \psi_j(H^t)|H^t)$. Since that quantity is subtracted from the left-hand side of (37) in the full equation (31), it means that $\psi_j(H^{t+1})$ must further compensate for that variation (by increasing if g_i is decreasing). Since we are interpreting equation (31) as a condition on ψ_j, the magnitude of $\pi_i(x_i^t, \psi_j(H^t)|H^t)$ must be viewed as a punishment that $\psi_j(H^{t+1})$ imposes on i for deviating from $\psi_i(H^t)$. Contrarily to the countervailing effect that involves only ψ_j, the values taken by π_i are inherently determined by ψ_i as well. In fact, the very equation $\pi_i(x_i^t, \psi_j(H^t)|H^t) = 0$ can be viewed as a restriction imposed by j on what x_i^t ought to be. For that reason, we call this the "expectation" effect: j is expecting what ψ_i player i will use and punishes him if he does not do so.

There is an entirely symmetric argument concerning the effects of ψ_i on j's payoffs. So i can also be seen as countervailing j and presuming of ψ_j if π_j is not identically nil. But as the theorem expresses, (31) must hold for both i = 1,2, with the *same* pair Ψ. This means that the equation $\pi_i(\Psi(H^t)|H^t) = 0$ must hold simultaneously for both i = 1,2. In other words, what i presumes must also be presumed by j and they must share what is usually referred to as a *common conjecture.*

Interestingly, as we demonstrate in the main text, this is not the case for the countervailing effect: each side may independently decide on how to countervail the other (in one of many ways) and still reach an SGPE. So the common conjecture requirement is weakened into the reciprocal assumption of countervailing behavior, meaning the choice of a countervailing strategy among a continuum of possibilities. This implies that players may shift from one countervailing strategy to another without explicitly renegotiating the terms of a common conjecture.

The trigger strategies that usually appear in the proofs of folk theorems exhibit a combination of countervailing and expectation effects. So our main theorem is neither a substitute for nor a consequence of the folk theorem. It simply focuses on another aspect of SGPE strategies

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that is neither predicted nor prohibited by the folk theorem. Besides, since one of our main objectives is to *reveal* the payoff structures, the folk theorem analysis could only be conducted ex post.

Appendix 4: Testing for the Expectation Effect

Our game-theoretic interpretation of U.S.-China relations in the 1970s and 1980s relies on the assumption that each country adopts a countervailing strategy. We provide here empirical evidence to substantiate this hypothesis. If the strategy of either China or the U.S. involves an expectation effect that entails punishments (for example, $\pi_{us} > 0$), this will result in a *coordination* of their two strategies, and our main theorem predicts that the discounted payoff each player would enjoy under countervailing strategies must be adjusted from (37) to (31). In the expectation effect, each player's move of date t should be explained by the opponent's *concurrent* and past plays as well as its own past play. Assuming that such expectations are linear, the U.S. move of date t should be predicted by

$$\begin{aligned} x_{us}^t &= \delta_0 + \delta_1 x_{ch}^t + \eta_1 x_{ch}^{t-1} + ..+ \eta_n x_{ch}^{t-1} x_{ch}^{t-1} + \nu_1 x_{us}^{t-1} + ..+ \nu_n x_{us}^{t-n} \\ &= \zeta_{us}(x_{ch}^t, \ldots, x_{ch}^{t-n}, x_{us}^{t-1}, \ldots, x_{us}^{t-n}) \end{aligned} \tag{38}$$

and, if coordination is present, deviations of x_{us}^t from $\zeta_{us}(x_{ch}^t, \ldots, x_{ch}^{t-n}, x_{us}^{t-1}, \ldots, x_{us}^{t-n})$ should lead to imposition of a punishment by China. We thus test for coordination by estimating the deviation of x_{us}^t from $\zeta_{us}(x_{ch}^t, \ldots, x_{ch}^{t-n}, x_{us}^{t-1}, \ldots, x_{us}^{t-n})$ and by computing the residuals of a regression of the U.S. move of date t against China's concurrent and past six moves as well as the past six U.S. moves. The absolute value of these residuals

$$\varepsilon_{us}^t = |x_{us}^t - \zeta_{us}(x_{ch}^t, \ldots, x_{ch}^{t-n}, x_{us}^{t-1}, \ldots, x_{us}^{t-1})| \tag{39}$$

may be interpreted by China as a symptom of U.S. deviation from a common conjecture and may be the basis of a punishment π_{us}. If this is the case, we would expect a significant positive weight μ_{us} on those residuals in the determination of the U.S. discounted payoff.[67] A similarly defined ε_{ch}^t should have significant positive weight μ_{ch} in the determination of China's discounted payoff if a coordination effect can be

[67] In other words, we assume that $\pi_{us} = \mu_{us}|x_{us}^t - \zeta_{us}(x_{ch}^t, \ldots, x_{ch}^{t-n}, x_{us}^{t-1}, \ldots, x_{us}^{t-n})|$, with $\mu_{us} \geq 0$.

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attributed to the U.S. strategy. Generalizing (17) to allow for such coordination yields

$$g_{us}(x^t_{ch}, X^{t-1}, X^{t-2}, \ldots, X^{t-n}) - \mu_{us}\varepsilon^t_{us}$$
$$= x^t_{us} - b_{us}x^t_{ch} + \omega_{us}g_{us}(x^{t+1}_{ch}, X^t, X^{t-1}, \ldots, X^{t-n+1}) \qquad (40)$$

and, as a straightforward generalization of (18), implies estimating

$$\begin{aligned}\omega_{us}\gamma_{ch}x^{t+1}_{ch} = {} & (1 - \omega_{us}\alpha^1_{ch})x^t_{us} + (\gamma^{ch} - b_{us} - \omega_{us}\beta^1_{ch})x^t_{ch} \\ & + (\alpha^1_{ch} - \omega_{us}\alpha^2_{ch})x^{t-1}_{us} + (\beta^1_{ch} - \omega_{us}\beta^2_{ch})x^{t-1}_{ch} \\ & + (\alpha^{n-1}_{ch} - \omega_{us}\alpha^n_{ch})x^{t-n+1}_{us} + (\beta^{n-1}_{ch} - \omega_{us}\beta^n_{ch})x^{t-n+1}_{ch} \\ & + \alpha^n_{ch}x^{t-n}_{us} + \beta^n_{ch}x^{t-n}_{ch} + (1 - \omega_{us})k_{ch} + \mu_{us}\varepsilon^t_{us}. \qquad (41)\end{aligned}$$

A μ_{us} that is not significantly different from zero is evidence against a coordination effect and in favor of pure countervailing play. Our system estimation for the period 1972 to 1979 yields

$$\begin{aligned}x^{t+1}_{ch} &= \underset{(.68)}{2.27} - \underset{(.10)}{.24}\,x^{t-1}_{ch} + \underset{(.09)}{.15}\,x^{t-4}_{ch} + \underset{(.12)}{.32}\,x^{t-3}_{us} - \underset{(.26)}{.18}\,\varepsilon^t_{us} \\ x^{t+1}_{us} &= \underset{(.09)}{.31}\,x^{t-1}_{us} - \underset{(.08)}{.18}\,x^{t-1}_{ch} - \underset{(.07)}{.22}\,x^{t-2}_{ch} - \underset{(.07)}{.15}\,x^{t-4}_{ch} \\ &\quad + \underset{(.065)}{.074}\,x^{t-5}_{ch} - \underset{(.11)}{.02}\,\varepsilon^t_{ch}. \qquad (42)\end{aligned}$$

For the period 1979 to 1988 our system estimates are as follows:

$$\begin{aligned}x^{t+1}_{ch} &= \underset{(.61)}{1.22} + \underset{(.08)}{.19}\,x^{t-1}_{ch} + \underset{(.08)}{.20}\,x^{t-3}_{us} + \underset{(.14)}{.02}\,\varepsilon^t_{us} \\ x^{t+1}_{us} &= \underset{(.66)}{-1.65} + \underset{(.09)}{.18}\,x^{t-2}_{ch} - \underset{(.17)}{.06}\,\varepsilon^t_{ch}. \qquad (43)\end{aligned}$$

In all cases the coefficients found on residuals ε^t_{us} and ε^t_{ch} are insignificant. We conclude therefore that the data do not support the hypothesis of coordination effects for either of the periods we consider.

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CHIPPING AWAY AT THE STATE
Workers' Resistance and the Demise of East Germany

By JEFFREY KOPSTEIN*

I. INTELLECTUALS AND WORKERS

IT has been but a few short years since the revolutions of 1989 and the collapse of communism in Eastern Europe, but already one finds an orthodoxy in historical interpretation. The standard story goes something like this: the key to understanding 1989 is political mobilization, first of the intellectuals and then of society at large. In the post-Stalin period, East European intellectuals gradually mobilized against the totalitarian state to reconstitute a civil society. When internal and external conditions permitted, the rest of society joined in and forced the communist parties from power.[1]

The standard story is essentially a whig history.[2] It is a comfortable one for intellectuals of all ideological positions, because whom does it

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[1] Daniel Chirot, "What Happened in Eastern Europe in 1989?" in Daniel Chirot, ed., *The End of Leninism and the Decline of the Left* (Seattle: University of Washington Press, 1991); Gale Stokes, *The Walls Came Tumbling Down* (Oxford: Oxford University Press, 1993); Timothy Garton Ash, *The Magic Lantern: The Revolution of 1989 Witnessed in Warsaw, Budapest, and Prague* (New York: Random House, 1990). This interpretation also implicitly informs most of the literature on democratization. See, for example, Michael Kennedy, "The Intelligentsia in the Constitution of Civil Societies in Post-Communist Regimes in Hungary and Poland, *Theory and Society* 21 (February 1992); Marcia Weigle and Jim Butterfield, "Civil Society in Reforming Communist Regimes: The Logic of Emergence," *Comparative Politics* 25 (July 1992); Tomasz Mastnak, "Civil Society in Slovenia: From Opposition to Power," *Studies in Comparative Communism* 23 (Autumn/Winter 1990); Paul Hirst, "The State, Civil Society and the Collapse of Soviet Communism," *Economy and Society* 20 (May 1991).

[2] The "Whig interpretation of history" was defined and criticized by Herbert Butterfield. It referred first of all to the historiography of England. It is a "tendency in many historians to write on the side of Protestants and Whigs, to praise revolutions provided they have been successful, to emphasize certain principles of progress in the past and to produce a story which is the ratification if not the glorification of the present." David Hackett Fisher, *Historians Fallacies* (New York: Harper Torch Books, 1970), 199. The term is also used as a generic synonym of "presentism," of which Whig history, in a narrow

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cast as the heros? Who are the dramatis personae of history? The intellectuals. To students of East European politics, such an analysis should come as no surprise. Intellectuals have long been regarded as playing a far more important social and political role in Eastern Europe than in other regions. Given the absence or weakness of other modern social groups, so the argument runs, intellectuals have historically been the most genuine and consistent carriers of "modernity."[3] Classical liberals find the mobilizational model pleasing because they understand civil society to mean the diminution of state power and the reinstituting of political and economic markets.[4] If the intellectuals lead the way, all the better. The standard story appeals equally to elements of the Habermasian left, who interpret East European intellectual mobilization as part of a larger social movement that has the potential to create an alternative, more genuine democracy. Civil society in such a democracy embodies not so much the political and economic market as a self-regulating public sphere—a reconstitution of the "life-world."[5] Rational choice models of 1989 also rely on intellectual mobilization. Since they consider popular dissatisfaction an insufficient condition for mass rebellion, the key players in rebellions are political entrepreneurs (intellectuals) who cleverly use selective incentives and break up the abstract goal of revolutionary overthrow into more palatable, concrete tasks of resistance to specific policies—thus overcoming the ubiquitous disincentives to collective action.[6]

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sense, is a particular species. "The past is evaluated in terms of the present, antecedent conditions in terms of the outcome." Stephen Cohen, "Bolshevism or Stalinism," in Robert C. Tucker, ed., *Stalinism: Essays in Historical Interpretation* (New York: Norton, 1977), 14. E. H. Carr also discusses the Whig history syndrome in *What Is History?* (New York: Knopf, 1962), 51.

[3] Zygmunt Bauman, "Intellectuals in East-Central Europe: Continuity and Change," *East European Politics and Societies* 1 (Spring 1987); Wolf Lepinies, "Fall und Aufstieg der Intellektuellen in Europa," *Neue Rundschau* 102, no. 1 (1990).

[4] Francis Fukuyama, *The End of History and the Last Man* (New York: Free Press, 1992).

[5] Jean Cohen and Andrew Arato, *Civil Society and Political Theory* (Cambridge: MIT Press, 1992); Andrew Arato, "Social Theory, Civil Society, and the Transformation of Authoritarian Socialism," in Ferenc Feher and Andrew Arato, eds., *Crisis and Reform in Eastern Europe* (New Brunswick, N.J.: Transaction Publishers, 1991).

[6] Rasma Karklins, "Decision Calculus of Protesters and Regimes: Eastern Europe in 1989," *Journal of Politics* 55 (August 1993); Ronald A. Francisco, "Theories of Protest and the Revolutions of 1989," *American Journal of Political Science* 37 (August 1993); Karl-Dieter Opp, "Repression and Revolutionary Action: East Germany 1989," *Rationality and Society* 6 (January 1994), as well as the other articles in the same issue. Where the rational choice and civil-society models differ, of course, is in their interpretation of the intellectuals' motivation. Whereas the civil-society school accepts the independent motivational force of the ethical ideal of civil society in explaining the behavior of the intellectuals, rational choice theorists interpret their behavior as a form of political entrepreneurship. These people, the finest minds of Eastern Europe, could easily have adapted to the existing system—indeed, many had—but chose to play a riskier game, for higher stakes. The price for defeat was imprisonment or exile, but the potential gain was the capture of the state.

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But is this how it really happened? Using materials from East German labor history, I argue here that the mobilizational model is at best incomplete, at worst a distortion. To be sure, political mobilization is part of the story; indeed, it may be the most dramatic part of the story. If scholarship of the past generation has taught us anything, however, it is that revolutions have causes rooted deeply in social and political structures.[7] Mobilization is but one stage in the revolutionary process, and one that appears relatively late in the game. What the standard story misses are the small-scale, largely nonpolitical acts of everyday resistance that chipped away at the long-term capacity of communist regimes to meet the demands of society at large. Instead of explaining how the East German regime was overthrown in a few months in 1989, I argue the case for how otherwise powerless workers could wear down a despotic state over four decades and thus make its overthrow an appealing strategy in the first place. One theoretical dividend of this essay, therefore, is a refinement of elite-centered explanations that have dominated studies of communism's demise.

In his study of everyday resistance among peasants, James Scott forcefully makes a point that could apply as well to East German workers:

> Their individual acts of foot dragging and evasion, reinforced by a venerable popular culture of resistance and multiplied many thousand fold, may, in the end, make an utter shambles of the policies dreamed up by their would-be superiors in the capital. Everyday forms of resistance make no headlines. But just as millions of anthozoan polyps create, willy-nilly, a coral reef, so do the multiple acts of peasant insubordination and evasion create political and economic barrier reefs of their own. It is largely in this fashion that the peasantry makes its political presence felt. And whenever, to pursue the simile, the ship of state runs aground on such reefs, attention is usually directed to the shipwreck itself and not to the vast aggregation of petty acts that made it possible.[8]

Scott's analysis suggests that, rather than concentrate mobilization and collective action, we shift the focus back to the everyday sources of regime immobilism. Such a shift in emphasis should help us identify the long-term patterns of public policy and resistance, and help answer the question of why East European regimes could not devise and im-

[7] Barrington Moore, *Social Origins of Dictatorship and Democracy* (Boston: Beacon Press, 1967); Theda Skocpol, *States and Social Revolutions* (Cambridge: Cambridge University Press, 1979).

[8] James C. Scott, *Weapons of the Weak: Everyday Forms of Peasant Resistance* (New Haven: Yale University Press, 1985), xvii. Scott's book builds on and simultaneously takes issue with Eugene D. Genovese's work on "day to day resistance to slavery." Genovese, *Roll Jordan Roll: The World the Slaves Made* (New York: Pantheon, 1974).

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plement effective economic policies that might have shored up their political legitimacy. Civil-society theorists are correct to criticize the totalitarian school for conflating communist attempts to gain total control over society with the reality of continuous engagement and compromise. Their one-sided concentration on people with the capacity to articulate their desires in print—the intellectuals—leads them, however, to misidentify the subject and nature of this long-term relationship between state and society. For all their vociferousness, intellectuals constituted a small part of East European society, and in most cases they were very well controlled and infiltrated by state security organs. For the better part of communist history, intellectuals did not resist in large numbers, though they now might like to suggest that they did.[9] Who did, then? Who resisted over the *longue durée* in Eastern Europe? In this paper, I argue that it was the workers, if not the working class. To be sure, with the notable exception of Poland, rarely did workers in Eastern Europe articulate their needs politically, but lack of voice should not be confused for absence of will or powerlessness.[10]

Power and the Powerless: The Question of Motivation

Having set out the type of social action to be examined—the everyday resistance of East German workers—I have yet to identify the motivation that lay behind this social action. What motivates subalterns to resist? This question continues to be a subject of heated scholarly debate. Is resistance the product of some communal moral vision, or does it reflect individual calculation of utility?

The first view is that held by moral economists.[11] Moral economists posit the existence of a tacit social contract in almost every long-standing social formation in which subaltern groups tolerate their own exploitation.[12] This tolerance lasts so long as a certain minimum existence is left beyond the realm of buying and selling; it is decommodi-

[9] Christian Joppke, "Intellectuals, Nationalism, and the Exit from Communism: The Case of East Germany," *Comparative Studies in Society and History* 37 (April 1995).

[10] For an early attempt to make this point, see Jan F. Triska and Charles Gati, eds., *Blue Collar Workers in Eastern Europe* (London: Allen and Unwin, 1981).

[11] James Scott, *The Moral Economy of the Peasant: Rebellion and Subsistence in Southeast Asia* (New Haven: Yale University Press, 1976). Since Scott's book, moral economy studies have become a virtual subindustry of the social sciences. For a good discussion, see "Peasant Strategies in Asian Societies: Moral and Rational Economic Approaches—A Symposium," *Journal of Asian Studies* 42 (August 1983).

[12] Barrington Moore, *Injustice: The Social Basis of Obedience and Revolt* (Armonk, N.Y.: M. E. Sharpe, 1988).

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fied. Violation of this prevailing norm, either by markets or states, invites resistance ranging from shirking, grumbling, foot dragging, false compliance, dissimulation, and other "weapons of the weak," to open strikes and other forms of collective action.[13] The ideal typical moral economy rebellion or strike is spontaneous, leaderless, and defensive. It occurs usually after a downturn or threatened downturn in some acceptable minimal standard of living.[14] Under most conditions, moral economists argue, exploited groups simply want to restore their previous living standards before the downturn. Rarely do they try to overthrow the existing order altogether.[15]

Scholars have demonstrated the existence of a tacit social contract and a moral economy in a number of industrial and proto-industrial settings.[16] Much more than the factory, however, peasant society has been the locus classicus of moral economy studies. Like workers, peasants are a subaltern, dependent political group. Their position as primary producers of the means of their own subsistence, however, makes their situation a special case of moral economy. In their respective studies of Vietnam and Russia, for example, both Scott and Shanin argue that the moral economy of peasants is essentially egalitarian and redistributionist.[17] Peasants conventionally develop institutions reflecting these ethical norms, the most important of which are encompassed in mutual assistance and in the redistribution of food among members of the community. Such ethics and their institutional expressions are rational strategies for spreading risk under conditions in which starvation is only one flood or famine away. Communal solidarity against the market and the state is not a matter of choice in the conventional sense, but rather a duty enforced by a rather strict moral code.[18] Recently scholars have applied many of these insights gleaned from agrarian social orders to the experience of workers on the shop floor.[19]

In their well-known attack, rational choice theorists note more than a trace of romantic antimarket sentiment among moral econo-

[13] Scott (fn. 8), xvi; Scott (fn. 11).

[14] Marsha Pripstein Posusney, "Irrational Workers: The Moral Economy of Labor Protest in Egypt," *World Politics* 46 (October 1993).

[15] Peter Swenson, *Fair Shares* (Ithaca, N.Y.: Cornell University Press, 1989).

[16] E. P. Thompson, "The Moral Economy of the English Crowd in the Eighteenth Century," *Past and Present* (February 1971); Charles Sabel, *Work and Politics: The Division of Labor in Industry* (New York: Cambridge University Press, 1982).

[17] Scott (fn. 11); Teodor Shanin, *The Awkward Class: Political Sociology of Peasantry in a Developing Society, Russia 1910–1925* (Oxford: Clarendon Press, 1972).

[18] Marcel Fafchamps, "Solidarity Networks in Pre-industrial Societies: Rational Peasants with a Moral Economy," *Economic Development and Cultural Change* 41 (October 1992).

[19] Moore (fn. 12); Posusney (fn. 14); Sabel (fn. 16).

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mists.[20] They argue that subalterns are no less selfish than other members of any given society.[21] The institutions and practices of peasant or worker solidarity do not arise spontaneously but require selective incentives and political entrepreneurs to ensure their continued existence and efficacy.[22] Similarly, on questions of resistance and rebellion, they argue that deprivation is not a sufficient condition for rebellion, nor will workers or peasants resist spontaneously. The free-rider and collective-action problems are simply too formidable.[23] Resistance and rebellion have less to do with dissatisfaction than with the various conditions under which the collective-action problem can be overcome.[24] Rebellion, rational choice theorists maintain, is opportunistic rather than defensive behavior. It occurs when risks are lowest (during times of plenty or tight labor markets) and when political entrepreneurs are present to help reduce the risk by framing the rebellion in terms of concrete issues that subaltern groups find compelling.[25]

In what follows I contribute to this debate through a study of everyday resistance and rebellion among East German workers. After considering the resistance to three types of labor discipline policies, I evaluate the single instance of sustained collective rebellion in East German history before 1989, the mass strikes in late June 1953. The long-term impact of this early resistance and rebellion on the capacity of the regime to devise and implement effective economic policies is considered in the final section. While the evidence reveals elements of everyday resistance and rebellion based on rational/individualistic and moral/communal models, on the whole I find that the moral economy perspective offers a more compelling account. It not only explains better the motivations of workers during the June 1953 strikes but, more importantly from the standpoint of this paper, it also accounts for the myriad acts of everyday resistance that so wore down the capacity of the state.

[20] William James Booth, "A Note on the Idea of Moral Economy," *American Political Science Review* 87 (December 1993).

[21] Samuel Popkin, *The Rational Peasant: The Political Economy of Rural Society in Vietnam* (Berkeley: University of California Press, 1979).

[22] Mark Lichbach, "What Makes Rational Peasants Revolutionary? Dilemma, Paradox, and Irony in Peasant Collective Action," *World Politics* 46 (April 1994).

[23] Mancur Olson, *The Logic of Collective Action* (New York: Schocken Books, 1968).

[24] Edward Shorter and Charles Tilly, *Strikes in France, 1830–1968* (Cambridge: Cambridge University Press, 1974).

[25] On this point, Posusney (fn. 14) cites the following works: Andrew Weintraub, "Prosperity vs. Strikes: An Empirical Approach," *Industrial and Labor Relations Review* 19 (October 1965); Bruce E. Kaufman, "Bargaining Theory, Inflation, and Cyclical Strike Activity in Manufacturing," *Industrial and Labor Relations Review* 34 (April 1981).

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II. German Workers under Soviet Rule

The Dilemma of Discipline

Before moving to the case studies of everyday resistance, it is necessary briefly to lay out the circumstances in which East German workers found themselves in the postwar period. It is a commonly held belief that the GDR started with a natural advantage among Leninist regimes—a developed industrial infrastructure and a highly trained, disciplined German workforce. Nowhere was this image of the German working class more deeply rooted than in the Soviet Union itself, a country that had developed intensive industrial, military, and intellectual ties with Germany in the interwar period. Stalin himself may have harbored typically Leninist doubts about the fundamental commitment of German workers to socialism, but he too deeply admired their discipline and efficiency. He admitted as much during the final stage of the war when he told Yugoslav communist Milovan Djilas, "[Germany] is a highly developed industrial nation with an extremely well qualified and numerous working class and technical intelligentsia. Give them 12 to 15 years and they'll be on their feet again."[26]

But whatever the Soviet hopes for the traditional German virtues of hard work and discipline in their own zone of occupation, the orientations and behavior of East Germans quickly changed under the impact of the difficult postwar conditions and Soviet labor practices. The East German worker of the immediate postwar era was not unlike R. H. Tawney's subsistence peasant, in water "up to the neck."[27] In the newspapers of the day, one finds moving reports of severe malnourishment among young workers.[28] The line between survival and starvation was one easily crossed. The collapse of the financial system, coupled with shortages in every sector of the economy under the weight of reparations payments, rendered monetary wages a weak instrument for tying labor to the workplace. With almost nothing to buy, it made little sense to work for money. Where money did matter, if one had a lot of it, was

[26] Milovan Djilas, *Conversations with Stalin* (New York: Harcourt, Brace and World, 1962), 103.

[27] R. H. Tawney, *Land and Labor in China* (Boston: Beacon Press, 1966), 77, cited in Scott (fn. 11), 1.

[28] Dietrich Staritz cites an especially moving article that was published in *Tribüne*, March 3, 1947: "We demanded that the enterprises conduct a medical investigation of its younger workers. We came to the conclusion that the enterprise youth is not gaining but losing weight and that the overwhelming portion of youths are considerably underweight. One of the most blatant cases recently is that of the 16 1/2 year only Liselotte W. who works in Tempelhof. She is 1.5 meters tall and weighs 26 kilos. Another youth from the same district is 1.69 meters tall and weighs 40 kilos. A fifteen year old is 1.38 meters tall and weighs 32 kilos." Staritz, *Die Gründung der DDR* (Munich: DTV, 1987), 206–7.

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on the black market. Black marketeers were universally despised but few workers could avoid frequent contact with them. Most workers spent several hours per day in black markets and several days each month roaming the countryside in search of food.[29]

Initially it was a matter not so much of getting East German workers to work hard as of inducing them to show up for work at all. In the two years following the war, absenteeism remained high and labor discipline lax. Of necessity, the ethic on the shop floor was egalitarian, cooperative, defensive, and geared toward survival rather than maximization of gain. The institutional expressions of this ethic were the spontaneously formed enterprise councils which, with Soviet toleration, came into existence in the final days of the war and flourished for about two years. The councils were typical moral economy institutions in that they both coordinated production and distributed equally to their employees a portion of their production and what little food and consumer goods (for barter) they could find.[30]

Enterprise councils have a rich history in German industrial relations, extending back to the Weimar period and in some cases before. In the postwar years, East German enterprise councils took on two new roles. First, they helped identify and root out active Nazis in industry, although in the case of management, the Soviet record on removing these officials was mixed.[31] Second, with many managers having fled to the West, councils performed the valuable service of getting production up and running again. But composed as they were of social democratic and communist workers, enterprise councils could hardly have been expected to increase labor discipline with the traditional tools of differential reward and labor segmentation.

Part of the reason that the councils retained a good deal of power well into 1947 was that the Soviet military authorities initially neglected labor altogether, preferring to focus on political reordering and sending eastward, in the form of war reparations, as much equipment and running production from German industry as possible. As long as enterprise councils did not interfere with these tasks, they were left to

[29] Klaus Ewers, "Der Konflikt um Lohn und Leistung in den volkseigenen Betrieben der SBZ/DDR" (Doctoral diss., University of Osnabruck, 1985), 24; Waltraud Falk notes that in 1947 Saxony had an absentee rate of 19.3 percent. Falk, *Kleine Geschichte einer grossen Bewegung* (Berlin: Dietz, 1966), 46.

[30] Siegfried Suckut, *Die Betriebsrätebewegung in der Sowjetisch besetzten Zone Deutschlands (1945–1948)* (Frankfurt: Haag & Herchen Verlag, 1982); Dietrich Staritz, *Sozialismus in einem halben Lande* (Berlin: Verlag Klaus Wagenbach, 1978), 104–6.

[31] Wolfgang Zank, *Wirtschaft und Arbeit in Ostdeutschland 1945–1949* (Munich: R. Oldenbourg Verlag), 53–54.

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run many enterprises as they saw fit. Two factors led the Soviets to begin to think systematically about labor discipline: (1) the disastrous winter of 1946–47, which led to widespread hunger and increased absenteeism, and (2) the onset of the cold war coupled with the recognition that the Soviet zone would remain part of the socialist camp for the foreseeable future. Responding to these social and political crises, the Soviet Military Administration in Germany (SMAD) called into existence a zonal economic authority, the *Deutsche Wirtschaftskommission* (DWK). But administrative centralization would not get to the heart of the problem—a demoralized and not very productive labor force. By the summer of 1947, East German labor productivity remained at less than half of its 1936 level. On October 13, 1947, therefore, the SMAD issued Order 234, what the East German trade unions subsequently called the *Aufbaubefehl* (construction order). Concomitant with the order, enterprise councils were disbanded or, when such action appeared to be too costly for the regime, subordinated directly to centrally directed trade unions.

In essence, Order 234 was a full-blown transfer of Soviet-style labor relations to East Germany, although initially it might not have appeared as such. The order called for a number of social measures to address the most urgent needs of workers: industrial safety, strict limits on the use of child labor, longer vacation time for workers involved in physically exhausting labor, polyclinics and nursing stations in the workplace, improved living conditions for workers, and increased wages for female workers. Most importantly, enterprises put on a "234 list" received special deliveries of food for the preparation of hot meals served in the works cafeteria and consignments of industrial consumer goods to be distributed directly at the workplace. Especially productive workers and those involved in hard physical labor received a type "A" meal. Those deemed less productive or performing less strenuous tasks received a less caloric and nutritious type "B" meal. This principle was to be used in the direct distribution of consumer goods at the workplace as well.

Order 234 also contained a number of measures to improve labor productivity. First and foremost came the fight against "slackers and corruption." "People's Control Committees" were set up in enterprises to stem the tide of shady dealings and petty pilfering that were bound to occur in a shortage economy. Absentee workers who could not produce a medical excuse could now have their ration cards taken away or, in extreme cases, be assigned to clear rubble from bomb sites which, along with construction, was among the most poorly paid work and

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was almost never included on the "234 lists" of enterprises receiving extra food.[32] Finally, the order called for the reintroduction of piecework and other forms of productivity-based wages throughout industry. To assist management in raising productivity, Soviet-style "socialist competitions" were to be employed, and those individual workers who contributed most to raising productive norms were to be designated "activists" and receive financial and political rewards.

Thus began the process of "sovietization" of the East German labor force. Through a subtle combination of incentives and sanctions, the particular Soviet method of binding the worker to the factory, of refashioning the factory as a social and political, as opposed to a purely economic institution, had begun.[33] Much of this, of course, was not new to German workers or managers. Industrialists such as Siemens and Zeiss had long understood the benefits of a *Sozialpolitik* internal to the enterprise.[34] Yet, as socially oriented as many German workers and industrialists may have been, they operated in a political and economic environment far different from the one confronting workers and managers in Soviet-occupied Germany in 1947. For one thing, the presence of the Soviet military authorities precluded the formation of anything like the independent employer and employee organizations that had hammered out personnel and wage policy in the Weimar era. The absence of legitimate interest representation meant that any wage settlement would be viewed by workers as suspect, as an expression of state policy or, worse, of Russian policy, rather than as the result of wage negotiations between nominally independent parties.

Beyond the legitimacy question, which of course would persist, East German managers faced a far different set of incentives than that faced by their prewar counterparts. Prewar German industry, for all the excesses of a highly organized internal market, still faced a modicum of domestic competition and the discipline of a highly competitive external market. These conditions no longer obtained for East German industry. Unlike the prewar industrialists, East German managers rarely worried whether their products would be marketed properly and ultimately bought. Pervasive shortages and Soviet reparation policy all but guaranteed that the entire productive capacity of almost any given en-

[32] Stiftung Archiv Massen- und Parteiorganisationen, Bundesarchiv (SAMPO-BA), SED IV 2/602/85.

[33] For a theoretical treatment of this process, see Andrew Walder, *Communist Neo-Traditionalism* (Berkeley: University of California Press, 1986), chap. 2.

[34] Heidurn Homburg, "The 'Human Factor' and the Limits of Rationalization: Personnel-Management Strategies and the Rationalization Movement in German Industry between the Wars," in Steven Tolliday and Jonathan Zeitlin, eds., *The Power to Manage: Employers and Industrial Relations in Comparative Historical Perspective* (London: Routledge, 1992).

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terprise could be sold. Rather than being determined by demand, the success of East German managers was a function of their ability to secure the necessary inputs of production, of which labor was among the most important.

Everyday Resistance: Food and Wages

The first signs of resistance from the shop floor reveal how easily the ethic of equality among workers could be violated by the most rudimentary tactics designed to segment the labor force. Although one million workers were receiving warm meals and extra consumer goods at their place of work within months after Order 234 was issued, differential access to food and consumer goods, on whatever basis, injured most workers' fundamental sense of justice. Essentially a crypto-marketization strategy to distribute rewards according to effort and political loyalty, the meal plan of the Sozialistische Einheitspartei Deutschlands (SED) invited wide-ranging acts of resistance. Segmenting the labor force and marketizing the reward structure made little sense to workers when, even with the supplementary meals, average daily caloric intake remained well below the daily minimum requirements. Not surprisingly, in April 1948, reports noted that workers continued to "eat from the same pot," and management still yielded to demands for the equal distribution of consumer goods despite the continued warnings from higher authorities.[35] Where management stiffened its resolve to increase wage and consumer goods differentials, workers often spontaneously evened out the differences by purchasing goods for each other.[36]

The nature and scope of the egalitarian impulse is best illustrated in the reaction to the reintroduction of piecework and other forms of productivity wages (*Leistungslohn*). Although the Nazis had left an unusually disorganized wage structure in industry, the tendency among enterprise councils was to level existing differences, not only among workers but between workers and technical experts. As part of the entire process of wage leveling, enterprise councils, almost without exception, opposed the reintroduction of wage practices common before 1945. Whereas before 1945, 80 percent of the workforce performed piecework and other types of *Akkordarbeit*, by April 1948 the proportion had fallen to 20 percent. Workers and enterprise councils spontaneously eliminated piecework and often removed time clocks at plant

[35] SAMPO-BA (fn. 32), SED IV 2/2027/22.
[36] State Department Decimal Files, XR862b.555/6-1053.

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entrances as symbols of work speedups and other distasteful aspects of capitalist (and Nazi) industrial life.[37]

When finally introduced, resistance to piecework and productivity wages was so formidable that within months the SMAD and the SED worried that Order 234 had devolved into an *Essenbefehl*, a one-sided welfare measure to feed industrial workers at their enterprises.[38] Workers complained, staged slowdowns, sabotaged piecework equipment, and used every method imaginable—short of collective action—for resisting its imposition. When asked by communist functionaries, workers voiced three reasons for resisting piecework in addition to egalitarian sentiments. First, Order 234 came as a final blow to many workers who had seen a steady whittling away of the powers of enterprise councils and their subordination to the officially guided trade unions. The withering of the only truly representative working-class institution confirmed working-class fears that piecework, even if introduced by a nominally working-class party, was simply a familiar vehicle of increased exploitation. A clear indication of these fears was the revival in 1947 of the traditional German working-class dictum "*Akkord ist Mord*" (piecework is murder) on the shop floor.[39]

Second, many workers who were in principle favorably disposed to increasing industrial discipline argued, with some justification, that any increase in productivity would flow directly into reparations and, as one worker put it, "benefit only the Russians."[40] While the total amount of reparations paid by East Germany to the Soviet Union remains a matter of scholarly dispute, the record is clear regarding the demoralizing effect reparations had on industrial workers. The head of the Soviet military authorities, Marshall Sokolovski, had guaranteed the SED leadership on January 11, 1947, that the dismantling of enterprises would be stopped. But a string of complaints from the SED and other evidence suggest that dismantling actually increased after this date.[41] Moreover, reparations from running production continued unabated. Officially, the SED claimed to have stemmed the tide of reparations, but as trade-

[37] SAMPO-BA (fn. 32), SED IV 2/2027/22; Suckut (fn. 30), 196.

[38] Ewers (fn. 29), 45.

[39] SAMPO-BA (fn. 32), SED IV 2/2027/22; see also Jörg Roesler, "Vom Akkordlohn zum Leistungslohn: Zu den Traditionen des Kampfes der deutschen Arbeiterklasse und zur Einfuehrung des Leistungslohnes in der volkseigenen Wirtschaft der DDR 1948 bis 1950," *Zeitschrift für Geschichte* 32 (1984), 778–95.

[40] SAMPO-BA (fn. 32), SED IV 2/2027/22.

[41] On Sokolovski's promise, see Horst Barttel, *Zur Wirtschaftspolitik der SED*, vol. 1 (Berlin: Dietz, 1984), 27; On the complaint, see Rainer Karlsch, "'Das Selbmann Memorandum' vom Mai 1947: Fritz Selbmann und die Reparationslasten der sächsichen Industrie," *Beiträge zur Geschichte der Arbeiterbewegung* 35 (1993), 88–125.

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union chair Herbert Warnke noted in April 1948, such claims were contradicted in the eyes of the population by the fact that the Soviets continued to walk into enterprises unannounced and take much of the production.[42]

Yet, even those workers resigned to piecework as an inevitable part of modern industry and to reparations as the cost of military defeat still protested that it made little sense to work for anything but hourly wages. Shortages in the energy sector and irregular deliveries of other raw materials virtually guaranteed each week that "after three days the raw materials are used up and in the remaining three days of the week there is nothing left to do."[43] Although the macro- and microeconomic conditions of the East German economy had changed for good, ordinary workers could not yet have known this. To them, idle capacity was a sure sign of impending layoffs, a condition that in these circumstances meant starvation.

Naturally, given the presence of the Red Army, the forms of resistance to piecework remained largely amorphous and disorganized—shirking, grumbling, work-to-rule, and dissimulation. In the event, however, such weapons apparently proved to be quite effective. Six months after the proclamation of Order 234, the portion of the labor force receiving piecework and productivity wages had risen a mere 3 percent. According to SED reports from the shop floor, many foremen could not be stopped from putting all the piecework tickets into a common urn in order to ensure equality of reward.[44] Difficulty in introducing piecework is further indicated by SED's strategy for introducing it. Rather than begin in the traditional centers of working-class power where it was likely to encounter stiff resistance, the SED concentrated initially on the textile enterprises of the *Oberlausitz* region, which employed mostly women, relative newcomers to the field of working-class politics in Germany. Not surprisingly, then, by the end of 1947 twice as many female workers received piecework wages as male workers.[45]

Everyday Resistance: Corrupted Taylorism

However persistent and convincing working-class resistance to piecework may have been, the unrelenting pressure from the Soviet military authorities and the SED departments left management in all branches of industry little choice but to find a way to follow orders. East German

[42] SAMPO-BA (fn. 32), SED IV 2/602/85.
[43] Ibid., SED IV 2/2027/22.
[44] Ibid., SED IV 2/5/232.
[45] Ibid., SED IV 2/602/85; Ewers (fn. 29), 48.

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management thus found itself in a no-win situation. Pressured on the one side by the Soviets and the SED to introduce piecework, and on the other side by the working class and its (increasingly powerless) enterprise councils to resist, management, in the end, did introduce piecework and productivity wages. In those cases where productivity wages were introduced honestly, wages immediately fell, and workers complained and often left for other enterprises. Fearing the loss of its workers, management responded by setting weak output norms that workers could easily meet and overshoot.[46]

The key to understanding management's behavior is the shortage economy. From the very outset of the Soviet occupation, managers were under pressure to produce as much as possible at whatever cost, a standard feature of Stalinist economic planning. Typical for the entire Soviet zone, in 1946 only 138 of the 465 state-run enterprises in Saxony operated at a profit.[47] Here we find the origins of the East German soft budget constraint. To be sure, even without the presence of the Red Army, the collapse of the German financial and transport systems at the end of the war rendered the hoarding of resources, especially labor, the sole rational economic strategy for producers of all kinds. But even after the East German currency reform in June 1948, which came as a response to the West German currency reform, the problem persisted. Hoarded labor became scarce labor, and scarce labor had more market power than if it were plentiful.[48]

Management's problem was to find a way to secure the necessary labor inputs to meet production plans. Whether the wage of a worker corresponded to his or her productive input was secondary. Under conditions of labor shortage and a soft budget constraint, then, management found it logical to regard the transition from time wages to piecework as a way to raise wages, through weak norms, and make their enterprises more appealing on the labor market. As such, rational managerial behavior transformed what was intended as an economic measure into a sociopolitical one.[49]

The SMAD and communist leadership responded with a redeployment of the prewar system of norm setting—using stopwatches, pro-

[46] *Arbeit und Sozialfürsorge*, no. 3 (1952), 494; SAMPO-BA (fn. 32), SED IV 2/602/85.

[47] Jörg Roesler, *Die Herausbildung der sozialistischen Industrie der DDR* (Berlin: Akademie Verlag, 1985), 82.

[48] As Zank (fn. 31) notes, labor was scarce, not because of any objective shortage, but because of other factors, such as poor bureaucratic deployment and other labor-market inefficiencies, as well as the expansion of uranium mining in Wismut.

[49] This source of managerial motivation became more pressing after 1948, when the numbers of people leaving the Soviet zone for the West shot up dramatically. Ewers (fn. 29), 75–77.

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duction-line time and motion studies, and the other elements of German Taylorism.[50] Yet, as tempting as it might have been to rely on earlier German traditions of industrial authority and management, East German Taylorism was corrupted from the outset by the environment in which it functioned. Like their prewar counterparts, East German managers could use the technocratic solutions of Taylorism neither to solve the problem of labor shortage nor to harmonize relations on the shop floor. The SED felt constrained to issue assurances that the use of capitalist methods did not imply the reintroduction of capitalism; workers were not competing against each other for their share of an overall wage bill. In March 1948 the SED issued orders that those who transferred to piecework or other types of performance wages were to be guaranteed an income 15 percent higher than what they received previously.[51] Two months later, *Tribüne*, the official newspaper of the trade unions, demanded that "the calculative and rational nucleus of rationalization be used without the technical exaggerations and without the capitalist intensification of work."[52] Taken together, these provisos hollowed out the core of classical Taylorism and amounted to a retreat by the political authorities in the face of labor's continued resistance on the shop floor and its position on the market.

In itself, paying a premium for piecework might not necessarily have been counterproductive had work norms been more closely watched. But with weak norms, piecework inevitably led to skyrocketing wage bills. The situation worsened after February 1948 with the introduction of "progressive productivity wages," which paid a premium over the piece rate for marginally greater production.[53] Although economic planning called for productivity to rise twice as fast as wages, "labor power" ensured just the opposite: wages rose much faster than productivity. In the Bitterfeld Electrochemical Combine, for example, wages rose in 1948 four times faster than labor productivity.[54] In the Maximillian forge, 80 percent of the workers had been put on progressive productivity wages by the end of 1948, but productivity norms dropped below where they had been eighteen months before, and, compared to the previous year, wages had risen 60 percent while labor productivity had dropped by 24 percent. Similarly disappointing results were re-

[50] On German Taylorism, see Heidrun Homburg, "Anfänge des Taylorsystems in Deutschland vor dem Ersten Weltkrieg," *Geschichte und Gesellschaft* 4 (August 1974), 170–94.

[51] SAMPO-BA (fn. 32), SED IV 2/2027/27.

[52] *Tribüne*, May 8, 1948, quoted in Ewers (fn. 29), 52.

[53] Exactly who came up with this idea remains unclear. Some discussion of it occurred among experts in the DWK in early February 1948. SAMPO-BA (fn. 32), SED IV 2/602/85.

[54] Ewers (fn. 29), 64–65.

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ported in the potash, iron, and coal-mining industries—as well as in other key sectors of the East German economy.[55]

In spring 1948, less than six months after the proclamation of Order 234, both the Soviets and the SED sounded the alarm on wages. In a letter to East German economics chief Heinrich Rau, a senior Soviet labor official warned that continued wage increases, "threaten the normal monetary circulation and the financial system of the [Soviet] Zone."[56] On orders from the Soviet military's labor department, the East Germans set to work on a new set of wage guidelines. These guidelines restricted the use of progressive productivity wages to essential industries and tightened norms in all branches.

Everyday Resistance: The Aktivist Movement

Commitment to higher norms was one thing; implementing this in practice was something completely different. Unable or unwilling to use the threat of unemployment as a tool for increasing labor discipline, the Soviets fell back on their own particular experience of industrialization in the 1930s to demonstrate that with enough dedication, ingenuity, and effort, work norms could be raised dramatically. The "activist" and "competition" movements had been initiated under Order 234 with precisely this idea in mind, but one year later, reports from the industrial provinces revealed that these movements had made little headway. East German managers had never before used socialist competitions. Most had no idea where to begin or what the fundamental organizing principles were. In many enterprises, workers were not even aware of when or in what sorts of competitions they participated.[57]

The SMAD decided that the movement needed a new push. Much as the "hero of socialist labor" Alexei Stakhanov had done as a coal miner in the 1930s, Adolf Hennecke, a fifty-one-year-old coal miner from Zwickau, mined 387 percent of his normal quota of coal for his shift under specially prepared conditions on October 13, 1948, the first anniversary of Order 234. Run as a political campaign, the "Hennecke-activist movement" soon spread across East Germany into every sector of the economy.[58] It is no accident that the movement began in a coal mine. Not only was coal in short supply, but with a relatively unskilled labor force and a work process that was amenable to arithmetic ac-

[55] SAMPO-BA (fn. 32), SED IV 2/2027/27; SAMPO-BA (fn. 32), SED NL 192/922.

[56] Ibid.

[57] SAMPO-BA (fn. 32), SED IV 2/2027/22.

[58] By the end of 1948 there were four thousand Aktivists, by the end of October 1950, one hundred forty-six thousand. Roesler (fn. 47), 85. These inflated numbers strongly suggest the dilution of what it meant to be an Aktivist.

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counting of individual work, methods of rate busting could be easily incorporated as political actions.

Hennecke's feat was supposed to inspire workers by demonstrating to the average person that it indeed was possible to do three and a half times the normal amount of work in a shift. Notwithstanding the spate of copycat record setting, however, one finds little evidence that the Hennecke movement actually increased labor productivity or that it convinced the working class of the need for higher norms. Most workers doubted the logic behind creating special conditions for one worker to produce faster than the norm for the simple reason that the normal work day simply did not function that way. One central committee instructor captured the attitude on the shop floor in his report of a visit to the Dresden Machine Building works during a "Hennecke Week" in December 1948:

> I asked three skilled workers from the enterprise about their opinion of the Hennecke movement. . . . All three immediately agree that the Hennecke movement would never work and would be discredited if "Hennecke shifts" [as such record-breaking shifts were referred to] continued to be prepared days in advance so that two or three workers could start well prepared.[59]

In an interview with a retired steelworker, historian Lutz Niethammer confirms the general impressions one gets from the archival record. Hennecke shifts were always possible as onetime affairs, but only with a considerable loss of time for readying materials and machinery:

> Only with such support was Hennecke the man. We had to clean everything in the morning and then they came in, and there stood the iron, impeccable, and they worked for eight hours, and they did something, didn't they? But it wasn't like that every day. That's not the way it's done. There is too much waste. It has to be cleaned up. You have to wash up this and that. The channels for the hot iron have to be built, don't they?[60]

The regime, moreover, could only partially use the activist and competition movements to raise norms. As Bendix notes, the activists and other rate busters tended to be despised and isolated by the rank-and-file employees of an enterprise.[61] Here we encounter, once again, widespread resistance to an obvious violation of working-class solidarity. The evidence on this point is overwhelming, not only from the testi-

[59] SAMPO-BA (fn. 32), SED NL 182/977.

[60] Lutz Niethammer, *Die Volkseigene Erfahrung*, (Berlin: Rowohlt-Berlin, 1991), 132.

[61] Reinhard Bendix, *Work and Authority in Industry: Ideologies of Management in the Course of Industrialization* (Berkeley: University of California Press, 1956), 331ff.

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mony of Hennecke himself, but also from those who followed in his footsteps. Activists regularly suffered abuse at the hands of their fellow workers. Many were labeled bloodsuckers, while others were spit upon; some even faced physical danger. The noted East German playwright Heiner Müller brought these passions to dramatic form in his 1958 work *Der Lohndrücker*, following a long tradition of such plays in the GDR. The play's hero, the activist Balke, addresses a member of his brigade after beginning the reconstruction of a blast furnace while the furnace is still hot, so that his factory will not shut down and the plan can be met:

> You've been blathering like mad about the rate busters. You don't want to understand what this is all about. You've thrown rocks at me [while I was in the furnace]. I used them for the wall. You beat me up, you and Zemke, as I came out of the oven.[62]

During the turbulent 1950s, the publication of works that had as their central theme the question of how otherwise recalcitrant workers could possibly be mobilized in support of socialist goals attests to a problem so large that it could not be ignored, even by a Stalinist cultural apparatus.

Given the frequency and intensity of resistance, in the end, Hennecke shifts and production records amounted to little more than political ritual. Control over this ritual, however, constituted an important arena of working-class politics and remained so for the next forty years. The attempt to create a Stalinist East German labor aristocracy failed in the face of a strong egalitarian working-class solidarity. But such evidence did not deter the continued use of Hennecke-like campaigns. On the contrary, within the SED bureaucracy there was some talk of appointing Hennecke and others like him as enterprise directors.[63] Hennecke himself even proposed the wholesale replacement of management in the mining industry with activists, once the latter had gone through special remedial courses in mathematics, science, and mining engineering.[64] While none of these plans came to fruition—indeed they were quickly

[62] Heiner Müller, "Der Lohndrücker," in *Geschichte aus der Produktion 1* (Berlin: Rotbuch Verlag, 1974), 43. The prototype of this hero appeared for the first time in Eduard Claudius's short story from 1950 "Vom schweren Anfang," which became the novel *Menschen an unserer Seite*. See the discussion in Peter Zimmermann, *Industrieliteratur der DDR: Vom Helden der Arbeit zum Planer und Leiter* (Stuttgart: J. B. Metzlersche Verlagsbuchhandlung, 1984), 83–87.

[63] SAMPO-BA (fn. 32), SED NL 182/977.

[64] Sobottka to Ulbricht, letter, April 19, 1949, SAMPO-BA (fn. 32), SED NL 182/977. The plan was withdrawn once the leadership understood that the remedial courses in mathematics and science would take three years to complete, followed by four years of course work in an area of specialization.

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slapped down at higher political instances—the Aktivist movement continued to enjoy high-level SED support, perhaps because it remained the sole device for breaking the egalitarian consensus among industrial workers, or perhaps because it nourished the illusion that workers might voluntarily produce more for less.

The evidence from the shop floor, however, shows that the workers would not produce more for lower wages. In the four years following Hennecke's feat, the SED employed dozens of "methods" to toughen work norms and standardize wage scales. The structure of the economy, however, and the solidarity of the working class within this structure made rate busting an unusually trying task. For all the discussion of "technically grounded work norms" and the presence of standardization bureaus in enterprises, constant interruptions in production due to the everyday chaos of the command economy rendered nearly impossible any accurate calculation of the relationship between labor and productive output. At best, norms could be a compromise between conditions at the workplace and downtime because of supply bottlenecks. At worst, they were mere guesswork.[65]

Furthermore, as noted above, the shortage of qualified labor and the existence of open borders yielded to labor an "exit option" that it might not otherwise have enjoyed.[66] If pushed too far, the more talented could pick up and leave for the West. During the economic upswing in the West following the West German currency reform in June 1948 and the concurrent economic downswing in East Germany because of its separation from the West, the problem of migration worsened.[67] Not surprisingly, every time the center attempted to reform the wage system, management catered to the egalitarian impulse of its employees and continued to even out wage differentials with funds supposedly set up for production bonuses.[68] Well into the early 1950s, despite

[65] By the end of 1951, only 10% of norms could be classified as "technically grounded." Ewers (fn. 29), 119. The sensitivity of workers to the rationalization bureaus is indicated in a report from September 1950. A rationalization official arrived at an enterprise and two days later offended workers and management by starting time and motion studies "with watch in hand" before consulting Brigade leaders. SAMPO-BA (fn. 32), SED IV 2/5/232.

[66] The fact that the tight labor market gave workers the power to resist appears to support the strand of the rational choice argument which holds that resistance is most likely to occur when risk to workers is lowest. Everyday resistance, however, did not subside after the construction of the Berlin Wall in 1961. In fact, it increased. Moreover, the reason for resistance, the pseudomarketization of production relations under conditions of shortage, remained unchanged.

[67] The population of the Soviet zone reached its height of 19.1 million in 1947. Thereafter it declined. Between September and December 1949, 129,000 people left; in 1950 198,000; in 1951 166,000; in 1952 over 182,000. Thomas Ammer, "Stichwort: Flucht aus der DDR," *Deutschland Archiv* 29 (1989), 1207.

[68] According to Roesler, in 1949, 59.4 percent of the director's bonus funds were used for direct payments to employees. Only 11% was used for production bonuses. Roesler (fn. 47), 70.

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their best efforts, the SED had still not gained control over the shop floor.

How do the moral economy and rational choice models of social action stack up against the record of everyday resistance? Although the evidence is far from one-sided, I tend to favor the moral economy model. For one thing, moral economy appears to predict the conditions under which resistance was initiated. It began in 1947 after the violation by the Soviets and the SED of a communal norm (decommodified egalitarian redistributionism) among workers and the emasculation of the institutions for implementing this norm (workers councils), both of which had flourished in an environment of dire scarcity at the end of the Second World War. The moral economy model also accounts for the dynamics of resistance; workers sustained and even intensified their strategies of everyday resistance when Stalinist repression was reaching its apogee in 1952. Rationally one would have expected increased repression to have stemmed the tide of everyday resistance, but the opposite occurred. Finally, moral economy is able to accommodate the fact that everyday resistance was largely leaderless, spontaneous, and undertaken without the use of selective incentives.

On the other hand, the evidence on resistance to piecework assembled here does not constitute a decisive refutation of rational choice models. One could easily reconstruct the elements of a rational choice story with the given evidence. Labor shortages and the exit option through open borders gave workers a power to resist, even in the face of formidable repression, that they might not have otherwise had. Both these conditions, coupled with managerial acquiescence, certainly lowered the costs and risks of everyday resistance. Furthermore, resistance was not as spontaneous as moral economy models might lead us to expect. Those who resisted did in fact employ selective incentives—incentives, to be sure, of a negative sort—against collaborators and those who refused to resist; witness the gradations of attacks against the Hennecke activists.

The presence of both communal and individual motivating factors in the above narrative suggests that extreme care must be taken in constructing a convincing test of moral economy and rational choice models of social order on the basis of everyday resistance. Motivations are not easily gleaned or isolated by the outside observer. Such difficulties arise not only because motivations are always mixed, but more importantly because everyday resistance is not designed to provoke a crisis in the short run. The barriers to its initiation and continuity are very low, especially when one compares it to the sort of sustained collective ac-

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tion that openly threatens the political order. For this reason, social scientists usually try to isolate motivating factors based on evidence from more dramatic, visible, and organized forms of resistance: strikes, rebellions, and other forms of collective action. Fortunately, East German history provides us with one very important instance of collective action, the countrywide strikes of June 1953. This event, to which I turn next, the first of its kind in communist Eastern Europe, provides us with critical evidence on the mind-set and motivations of German workers under communism.

From Everyday Resistance to Collective Action

The cat-and-mouse game between state and class that evolved after 1947 might have carried on undisturbed had the cold war not taken a new turn. After the rejection of the second Soviet "Germany Note" by West Germany, followed by Adenauer's signature to the European Defense Community Treaty in May 1952, Stalin decided on the full integration of the GDR into the Eastern Bloc. Under Soviet orders, the East Germans committed themselves to building up their armed forces and defense industry at a cost of 1.5 billion marks, to be financed from reductions in social spending coupled with higher taxation.

In July 1952, the SED quickly convened a party conference where it announced the "planned construction of socialism in the GDR." Apart from the ideological bluster, in the economy the shift amounted to a new emphasis on investment in heavy industry, forced collectivization of agriculture, and discriminatory taxation against the remaining private industrial enterprises. As a result of the collectivization campaign, 40 percent of the wealthier farmers in the GDR had fled to the West, leaving over seven hundred fifty thousand hectares of otherwise productive land lying fallow.[69] Already in November 1952, West German newspapers reported sporadic food riots and industrial unrest in the major industrial centers of the GDR, including Leipzig, Dresden, Halle, and Suhl. By spring 1953, severe food shortages hit the cities and, as punitive taxation on the private sector effectively shut down crucial suppliers of the state sector, consumer goods began to disappear from the shelves too.[70]

[69] SAMPO-BA (fn. 32) SED NL 182/1077.

[70] News release of November 17, 1952, from the Agency Inter-Continent Correspondence, noted in Department of State file 762b.00/11-2452, November 24, 1952. In January 1953, Stefan Thomas, chief of the West German SPD Eastern Affairs Bureau told State Department officials, "At present the unrest has reached the degree where uprisings would break out if called for by the West. The unpopularity of the regime is especially evident now owing to the food shortages and to agricultural collectivization measures." Ibid.

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Faced with the inflationary pressures of increased defense spending and declining agricultural and industrial output, the SED leadership had little choice but to attack industrial wage inflation. In May 1953, the SED announced an across-the-board norm increase of 10 percent, set according to strict technical standards. Such an increase might once again have been undermined at the enterprise level and gone unnoticed had it not been accompanied by other unprecedented measures: increases in prices for food, health care, and public transportation. Taken together, the norm and price increases amounted to a 33 percent monthly wage cut. Despite the confusion in the leadership following Stalin's death in March, the Soviet leadership retained enough internal cohesion to respond to the numerous SMAD reports that pointed to the strain these policies had put on East German society. In a series of meetings with the SED leadership, the Soviets "suggested" a number of steps for the GDR's economic recovery. The SED followed most of the Soviet recommendations, but, curiously, did not rescind the industrial-norm increases.[71]

On June 16, workers at several Berlin construction sites walked off the job, demanding a reinstatement of the old norms. On the next day, June 17, approximately five hundred thousand blue-collar workers went on strike and four hundred thousand East Germans demonstrated in 272 cities and towns throughout the GDR.[72] Public authority quickly broke down. Wage demands quickly turned into political demands for free elections and unification with the West. In the end, SED rule could only be preserved with the help of Soviet tanks.

Seen in retrospect, the June events were typical moral economy protests. First, workers moved from everyday resistance to collective action only when they perceived a true threat to their communal standard of living. Had they been purely selfish and individualist actors,[73] groups

[71] Nadija Stultz-Herrnstadt, *Das Herrnstadt Dokument* (Hamburg: Rowohlt, 1990), 82–84. As an indication of the continued hard line on wages, a *Neues Deutschland* article appearing at the end of May 1953 made the argument that even though increased labor productivity lowered production costs, this did not mean that workers should receive higher wages, at least for the foreseeable future. It concluded by pleading with workers to discard old norms so that productivity could rise more rapidly than wages. Only after this had been achieved, so the argument went, could the standard of living could be raised. Department of State, East Germany, file 762b.00/5-1953 XR 962a.61 The resolution introducing the new course was published on June 11, 1953.

[72] Wolfgang Eckelmann, Hans Hermann Hertle, and Rainer Weinert, *FDGB Intern: Innenansichten einer Massenorganisation der SED* (Berlin: Treptower Verlagshaus, 1990), 22.

[73] The conception of social action as aggregated individual behavior based on the maximization of expected utility is a staple of rational choice theory. Mark Lichbach, *The Rebel's Dilemma* (Ann Arbor: University of Michigan Press, 1995). Selfishness, or at least an absence of altruism in the formation of preferences, is also usually implied, although some scholars qualify their notion of rationality to include nonmaterial rewards and preferences for community. See Russell Hardin, *Collective Action* (Baltimore: Johns Hopkins University Press, 1982).

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of workers who might have benefited from stricter piece rates and output norms and who had much better working conditions, such as those working in Soviet-owned enterprises, should have been less willing to strike. Research shows, however, that "Soviet" Germans were at least as active as their counterparts in East German state-owned enterprises.[74] This suggests that sentiments of solidarity outweighed any selective incentives employed by the Soviet military authorities to ensure loyalty. In fact, the workers least likely to strike appear to have been employed in the remaining private enterprises.[75]

Second, workers did not wait until their living conditions improved or appeared more secure, as rational choice theory would lead us to expect, nor did they wait until the risk of retribution was low. Given Stalin's death in March 1953, it might appear as if protests did indeed occur when the risks decreased. But East German workers could not have known two months after Stalin's death whether the Soviet leadership had made a decision to rein in the Stalinist police apparatus. Such considerations remained, at best, speculations in the West, and internally were regarded as closely guarded state secrets, the documentation for which has only recently been discovered. Protesting in June 1953 remained a high-risk activity, an "irrational" act.[76]

Third, the protests were primarily restorative as opposed to opportunistic.[77] Workers demanded primarily a restoration of preexisting wage levels and output expectations.[78] It is true that wage demands quickly accelerated to political demands for free elections and unification, but it is also true that most workers quickly returned to work after the regime guaranteed that output norms would be restored to their previous level. As Arnulf Baring notes in his still classic study of the June 17 protest, the backbone of the strike movement had been broken by regime concessions well before the Soviets marched in, despite the fact that scattered strikes continued well into the next month.[79]

Fourth, and most importantly, one finds a notable absence of political entrepreneurs using selective incentives among the strikers. Intellectuals remained passive and largely proregime.[80] During the strikes

[74] "Die SAG-Betriebe und der 17. Juni 1953," *Deutschland Archiv* 29 (1992), 531–36.

[75] Bundesarchiv Abteilungen Potsdam (BAP), 13/33.

[76] For a detailed discussion of this point, see Jeffrey Kopstein, *The Politics of Economic Decline in East Germany, 1945–1989* (Chapel Hill: University of North Carolina Press, forthcoming), chap. 2.

[77] Posusney (fn. 14) identifies this trait as constitutive of moral economy protests.

[78] Torsten Diedrich, *Der 17. Juni 1953 in der DDR* (Berlin: Dietz Verlag, 1991), 72–76.

[79] Arnulf Baring, *Der 17. Juni* (Cologne: Kiepenhauer and Witsch, 1956), 89.

[80] Nikola Knoth, "Loyale Intelligenz? Vorschläge und Forderungen 1953," in Jochen Cerny, ed., *Brüche, Krisen, Wendepunkte* (Leipzig: Urania-Verlag, 1990), 149–56; Anke Huschner, "Der 17. Juni an Universitäten und Hochschulen der DDR," *Beiträge zur Geschichte der Arbeiterbewegung* 33, no.5

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and afterward, the Soviets and the SED argued that the whole affair was led by former Nazis within the GDR and from abroad. Although a disproportionate number of political undesirables and former Nazis worked in the construction sector, where the strikes began, SED attempts to identify ringleaders and a core leadership of the strikes among this group have not held up under scrutiny, nor have their accusations that the leadership came from the West fared any better.[81]

The archives demonstrate quite clearly that the strikes were leaderless, unplanned, and unexpected.[82] They began in construction because, as the most poorly paid labor, construction workers were especially sensitive to changes in output norms and consumer prices.[83] Furthermore, however many provocateurs may have come from the West, the simple fact is that the protests started and spread too quickly for any leadership to have taken control and provided direction.[84] The absence of leaders rendered the strikers and demonstrators rather aimless in their demands and tactics; at times it was unclear whether the workers' demands were economic or political in nature, as they did not speak with a single voice. But the absence of political entrepreneurs did not prevent the initiation of collective action that threatened to bring down the regime.

III. Resistance and Rebellion: The Long-Term Impact

The Labor Pact

Whatever the ultimate motivation for working-class resistance and revolt, even more important than the immediate shock were the long-term effects of the strikes on the East German political economy. One month after the June uprising, a report to the general secretary of the Christian Democratic Union, the most important of the SED-aligned

(1991); Heinrich Mohr, "Die 17. Juni als Thema der Literatur in der DDR," in I. Spittmann and K.W. Fricke, eds., *17. Juni 1953* (Cologne: Edition Deutschland Archiv, 1982).

[81] Gerhard Beier, *Wir wollen freie Menschen sein. Der 17. Juni 1953, Bauleute gingen voran* (Cologne: Bund, 1993); Rainer Gries, "Westliche Markenprodukte waren die schlimmsten Provokateure: Vorsorgung und Propaganda in der DDR am Vorabend des 17. Juni 1953," *Das Parlament* 42, nos. 25–26 (1992).

[82] This is the main conclusion of Diedrich's archival work, Diedrich (fn. 78). See also Armin Mitter, "Die Ereignisse im Juni und Juli 1953 in der DDR: Aus den Akten des MfS," *Das Parlament* 41, no. 5 (1991); Heidi Roth, "Der 17. Juni im damaligen Bezirk Leipzig: Aus den Akten des PDS-Archivs Leipzig," *Deutschland Archiv* 24 (June 1991).

[83] In Gera, Magdeburg, Rostock, and Dresden, the strikes began not in construction but in steel and metalworking. Eckelmann, Hertle, and Weinert (fn. 72), 28.

[84] Diedrich (fn. 78), 156; Roth (fn. 82), 575.

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bloc parties, warned that "under a seemingly calm surface [lay] dangerous seeds of discontent," and concluded "that an external calm exists in the population and in reality the mood has in no way improved since June 17, 1953."[85] The SED could hardly have been less affected by the mood of the population than its sister party, since most public anger was directed at Ulbricht, Pieck, Grotewohl and other leading communist luminaries. In fact, from the testimony of his colleagues, we know that throughout the 1950s, SED leader Walter Ulbricht feared, more than anything else, a repetition of the events of June 17.[86]

Politically charged industrial unrest had almost cost Ulbricht his job and, given the clear connection between unrest and wage/price policy, Ulbricht had good reason to avoid making this mistake again. It appears certain that Ulbricht feared his own working class. Not surprisingly, then, the uprising in June effectively crippled the regime on the shop floor. Output norms and prices quickly returned to the status quo ante. In order to buy labor quiescence, the SED continued to corrupt the entire Taylorist apparatus set up for measuring old norms and implementing new ones. Taylorism's corruption in the East German context did not decrease the allure of the pseudoscientific and technocratic language so present in the various charts, graphs, and equations that litter the regime's labor studies of the 1950s.[87] Gradually, however, the outlines of an implicit agreement between the workers' state and the working class began to take shape: production could rise so long as norms remained low and wages high, relative to productivity. Industrial unrest did reappear sporadically throughout the 1950s, as the regime tried time and again to manipulate wages and norms. But enterprise party organizations and management had little interest in creating unnecessary industrial conflict and, in the few cases of conflict that have been studied thoroughly, both tended to acquiesce to whatever industrial demands workers might make.[88]

Throughout the 1950s wages rose faster than productivity in every sector of industry, a problem that Soviet advisers and the East German leadership would repeatedly attempt to rectify, albeit with little suc-

[85] Archiv für Christlich-Demokratische Politik, VII-011-1743. Reprinted in Udo Wengst, "Der Aufstand am 17. Juni 1953 in der DDR: Aus den Stimmungsberichten der Kreis- und Bezirksverbände der Ost-CDU im Juni und Juli 1953," *Vierteljaharhefe für Zeitgeschichte* (1993), 277–321.

[86] Ernst Wollweber, "Aus Erinnerungen: Ein Porträt Walter Ulbrichts," *Beiträge zur Geschichte der Arbeiterbewegung*, no. 3 (1990), 350–78.

[87] Werner Mühlhausen and Richard Schmidt, *Arbeitsanalyse und Arbeitsnormung: Ein Kernstück des praktischen Unterrichts in der sozialistischen Produktion* (Berlin: Volk und Wissen Volkseigener Verlag, 1959).

[88] Peter Hübner, "Balance des Ungleichgewichtes: Zum Verhältnis von Arbeiterinteressen und SED-Herrschaft," *Geschichte und Gesellschaft* 19 (1993), 26.

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cess.[89] Twelve years after the June events, for example, when the management of the Oberspree Cable Works tried to adjust piece rates in the first half of 1961, a report of the Committee for Labor and Wages lamented that "the workers declared that if new piece rates were introduced, they would take up work in another enterprise. Five workers took the discussion about the use of new rates, which would not have led to any wage reductions, as cause to quit."[90] In the same year, a member of the economic council of Rostock could characterize only 15 percent of the wages in his province was subject to any kind of rigorous standardized output norms.[91]

Even though industrial relations could be stabilized on the basis of high wages and low productivity, this arrangement did not in any way relieve the pressure on the regime to improve economic performance. It merely restricted one path of capital accumulation—through wage suppression—and rendered economic competition with the West that much more difficult. Wage egalitarianism remained a constant of East German industry; in fact, over the years it gradually became a social norm.

As an older generation of East Germans resumed its place and a new generation entered the workforce after 1945, both developed habits, interests, and expectations that were different from those of the working class of prewar Germany. The work ethic and culture of the East German working class had been completely refashioned. In the absence of a capitalist labor market, the egalitarian impulse developed in the early postwar years could not be broken, as it was in the West. As wages lost their disciplinary and stimulative functions, however, other traditional German working-class virtues fell by the wayside. Thus, by 1960, East Germany had a higher rate of absenteeism among industrial workers due to "illness" (shirking, one of the weapons of the weak) than any other country in Soviet-controlled Eastern Europe.[92] East German labor had become as much a constraint as a productive resource, and this constraint in no small way helped to restrict the scope of plausible economic reforms.

[89] Andre Steiner, "Sowjetische Berater in den zentralen wirtschaftsleitenden Instanzen der DDR in der zweiten Hälfte der fünfziger Jahre," *Jahrbuch für Historische Kommunismusforschung* (June 1993), 100–117.

[90] Quoted in Jörg Roesler, "Wende in der Wirtschaftsstrategie: Krisensituation und Krisenmanagement 1960–62," in Jochen Cerny, ed., *Brüche, Krisen, Wendepunkte* (Leipzig: Urania Verlag, 1990).

[91] Alf Lüdtke, "Helden der Arbeit—Mühen beim Arbeiten: Zur missmutigen Loyalität von Industriearbeitern in der DDR," in Hartmut Kaelble, Jürgen Kocka, and Hartmut Zwahr, eds., *Sozialgeschichte der DDR* (Stuttgart: Klett Cotta, 1994), 211.

[92] Hübner (fn. 88), 26.

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The Aborted Reform

In the long run, the labor pact of the 1950s weakened the regime by eliminating the possibility of meaningful economic reform. Such reforms were universally regarded as necessary if the East was to compete effectively with the West. Yet by 1974, when confronted with the facts of his country's faltering economic performance and of the need to place the burden of adjustment to a rapidly changing international economic environment on the working class, the East German leader, Erich Honecker, could only respond by admonishing his Politburo colleagues: "In that case we can all resign immediately, and that naturally is something we don't want to do."[93]

Honecker spoke from experience, for he had been second in command to Walter Ulbricht during the GDR's only serious attempt to restructure its economy. Between 1962 and 1970 the SED undertook a rather ambitious "in-system" economic reform. The essence of East Germany's economic reform, known as the New Economic System (NES), was similar to other reforms undertaken within the former Soviet bloc. In one way or another, all the reforms were designed to address the critique first put forward by von Mises and Hayek: in complex economies planners face an almost insurmountable task of obtaining accurate information from producers and consumers. With this in mind, East German planners sought to improve their knowledge of enterprise performance and induce the production units under their command to utilize resources more efficiently through a price reform, a capital charge, and an evaluation of enterprise performance based on profit rather than physical output. Planners understood that capital productivity would remain lower in the East than in the West for some time to come, but they hoped that rising rates of capital accumulation and continued high rates of investment would gradually push East Germany past the West in a number of industries.[94]

Social scientists have offered a simple and elegant explanation for why communist reforms fail. Notwithstanding some good intentions, reforms ultimately founder, so the argument goes, because marketization threatens the benefits accrued to rent-seeking bureaucrats who, in a market economy, will no longer be the administrators of shortage.[95]

[93] BAP (fn. 75), SPK E-1 56167.

[94] Jeffrey Kopstein, "Ulbricht Embattled: The Quest for Socialist Modernity in the Light of New Sources," *Europe-Asia Studies* 46 (June 1994).

[95] This literature is nicely summarized in Jan Winiecki, *The Distorted World of Soviet-Type Economies* (Pittsburgh: University of Pittsburgh Press, 1988).

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Given a choice between efficiency or power, communist bureaucrats choose power every time. How does the theory hold up when confronted with the evidence? The archival evidence on the rise and demise of the East German economic reforms during the 1960s reveals motivations of a more complex nature. Middle- and upper-level officials who opposed the reforms did so not because they were afraid of losing power, but because regulating a reforming economy was so much more complicated and difficult than administering a Stalinist economy.[96] Their private correspondence portrays men concerned more with a poorly functioning, half-reformed, Gorbachev-style economy, than with their diminished power in the face of decentralization.[97]

What the evidence supports much less ambiguously is the power of the working class to restrict the range of reforms. Having started with an alteration of industrial prices, by 1965 the entire price system, especially consumer prices, had to be changed if the NES was to have any chance of success. Most of the economic elite agreed with the head of the state bank, Gretta Wittkowski, who asserted quite bluntly in July 1965, "We have to get rid of the idea that consumer goods prices will stay unchanged." The head of the state planning commission, Erich Apel, agreed with her. Although he foresaw a solution to the problem only in the future, he predicted that many consumer prices would have to change quickly if the price reform was to provide useful information to the planners.[98]

The issue of consumer goods prices did not disappear. But Ulbricht, committed as he was to the NES, refused to act. In February 1966, Chairman of the Council of Ministers Willi Stoph informed Ulbricht that it would soon be necessary to start thinking about making "corrections" in consumer prices because of the impact of the industrial price reform.[99] Ulbricht, however, did not yet feel confident enough to broach the question of consumer prices in public. He personally oversaw several drafts of the official *Argumentation* for the third and final stage of the industrial-price reform, making sure that it was clear that consumer prices would not be affected.[100] Of course, Ulbricht was not alone. In both the party and the state bureaucracies, many felt that for political reasons the burden of reform could not yet politically be

[96] Kiren Aziz Chaudhry argues that, more than ideology, this logic shaped the original decision to move to a command economy in the Soviet Union in 1928. Chaudhry, "The Myths of the Market and the Common History of Late Developers," *Politics and Society* 21 (September 1993).

[97] Kopstein (fn. 94).

[98] BAP (fn. 75), SPK E-1 51770.

[99] SAMPO-BA (fn. 32), SED NL 182/973.

[100] Ibid.

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shouldered by the public. The memories of June 1953 were still too fresh.

Beyond consumer prices, industrial relations remained off-limits as well. Investing according to profitability ultimately meant closing down or scaling back unprofitable enterprises. Such a radical departure would entail, at a minimum, tens of thousands of "socialist transfers"—retraining and relocating workers, if not outright unemployment. In 1966–67 when this process was due to begin, the response was a typical moral economy "entitlement protest."[101] Steady, lifetime employment at one enterprise (unless voluntarily given up by a worker) was considered an essential part of the social contract, and its violation constituted in the minds of many a surrogate form of unemployment. Those threatened with transfers to new work put up stiff resistance. Coal miners and their managers in Zwickau, for example, brought the situation to the edge of revolt. In the face of these prospects, plans to close down certain parts of the coal mine were quickly dropped. Budgets remained soft, therefore, not only because rent-seeking communist officials wanted them to but also because the regime had little choice in the face of workers' resistance.[102]

In addition to job security, the issue of piece rates, output norms, and wage levels continued to plague SED labor specialists. Despite the relative peace on the shop floor in the years after 1953, in 1960 the central trade union still recorded 166 work stoppages or strikes mostly because of administrative adjustments in wages or piece rates.[103] Although the construction of the Berlin Wall seemed to offer the SED the opportunity finally to address the problem of wages outpacing productivity, such confidence proved illusory. The SED leadership considered it safe to raise piece rates and exert downward pressure on wages through an imposed *Produktionsaufgebot* (production levy) after the construction of the wall in August 1961. Thanks to this, as well as to a series of policies designed to absorb excess earnings, the relationship between labor productivity and wages improved temporarily.[104] But even with the closure of the West German labor market, labor protests did not subside. In fact, they increased in the year after the construction of the wall. Trade union reports of 135 strikes in 1961 and 144 strikes in 1962 dashed any

[101] Posusney (fn. 14).

[102] On the Zwickau unrest, see Werner Obst, *DDR Wirtschaft: Modell und Wirklichkeit* (Hamburg: Hoffmann und Campe, 1973), 91. Many officials opposed the closing of the enterprises because they considered it unjust to disrupt the "brigade" and "enterprise" life of the workers, suggesting that a moral economy existed not only among workers, but among management as well.

[103] SAMPO-BA (fn. 32), SED IV 2/611/66.

[104] BAP (fn. 75), SPK E-1 51770.

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possible hopes among the SED labor specialists that the wall would decisively alter industrial relations or working-class attitudes.[105] These strikes remained disjointed and amorphous affairs. In no instance did they directly threaten to upset political authority. In almost every case they involved piece-rate or output-norm issues and could easily be resolved by managerial retreat. Nonetheless, within several years, all ground gained had been lost. By April 1966 wage increases once again outpaced productivity gains in seven of eight mining trusts, in three of five trusts in metallurgy, and in nine of fourteen trusts in machine building.[106] In late 1965 and early 1966, consideration by the Council of Ministers of instituting a five-day workweek, every other week, would have simply been a ratification of concurrent practices in many enterprises and suggests that labor continued to represent as much of a constraint as a resource.[107]

The capacity of workers to undermine pseudomarketization of both the internal and the external capital and labor markets explains to a large extent why such reforms were never undertaken again. Yet without significant change, the East German economy was doomed to fall farther behind its West German counterpart with each passing year—a primary, if not exclusive, reason for communism's collapse in 1989. Whether genuine economic reform might have saved East Germany remains unclear. It may not have been a sufficient condition, but it certainly was a necessary one. Even where they disagree on the modalities of the transition, social scientists do agree that marketization of some sort is a precondition for improving the long-run performance of Soviet-type economies.[108] If it could have been carried out successfully—that is, if the soft budget constraint could have been diminished—there is no reason to believe that the reforms prevented by the workers would not have improved economic performance and shored up the regime's legitimacy.[109] Notwithstanding the number of recent studies on democ-

[105] Andre Steiner, "Ökonomische und soziale Effekte von Mechanisierung und Automatisierung in der Metallverarbeitenden Industrie der DDR von den fünfziger bis in die siebziger Jahre," *Deutsche Studien* 115 (1990), 305.

[106] BAP (fn. 75), SPK E-1 56087.

[107] Ibid.

[108] On this common prescription from two politically very different points of view, see Adam Przeworski, *Democracy and the Market* (Cambridge: Cambridge University Press, 1991); also Oliver Jean Blanchard, Kenneth A. Froot, and Jeffrey D. Sachs, eds., *The Transition in Eastern Europe* (Chicago: University of Chicago Press, 1994).

[109] During the initial years of the reform in the 1960s, the GDR's economic performance improved significantly. Gert Leptin and Manfred Melzer, *Economic Reform in East German Industry* (Cambridge: Cambridge University Press, 1978). The upswing stalled as soon as working-class resistance impeded the broadening and deepening of the reforms. Put differently, if by 1989 East Germany's economy had been performing near the level of the West, the regime might have allowed its people to travel, secure

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ratization, one finds very little solid evidence that dictatorships cannot be rendered legitimate for long periods of time by elites who have sufficient room for maneuver. East German workers, conditioned by their historical relationship with the Communist Party, ensured that the elite did not enjoy this luxury.

IV. Conclusion

In his classic study of the nascent English working class, E. P. Thompson argued that the moral economy of the crowd in the eighteenth century effectively restricted the capacity of the state to introduce procapitalist policies.[110] Only during the next century, the nineteenth, could the traditional Tory socialist coalition of elite and mass be broken. An analogous, if not identical, situation can be said to have existed in postwar Eastern Europe. Western experts have argued that during the 1970s and 1980s, that is, in the later years of communist rule in the Soviet Union and Eastern Europe, an implicit social contract between state and society effectively restricted the room for maneuver enjoyed by these regimes.[111] The historical evidence presented in this article, however, suggests that this confining condition was encountered much earlier than previously thought, almost from the very outset of rule. Despite the imposing presence of the Soviet occupation regime and the growing power of the SED, the East German working class retained an amorphous, disorganized power that, even with a good dose of Stalinist terror, could not easily be diminished. The power of the totalitarian state to shape a new moral economy, to create a new structure of consent among the working class, was extremely limited. Along with job security, East German workers had the power to demand a rough-and-ready sort of wage egalitarianism and consumer prices that remained low relative to wages. The contradiction of the communist social contract was that, despite persistent egalitarianism, East German workers expected a standard of living on a par with that of their counterparts in the West and reserved the right to feel a sense of injustice when this relationship went too far askew. From the standpoint of the country's

that they would return. To extend the counterfactual, if reasonable economic parity could have been achieved, how many ordinary East Germans would have joined the pampered intellectual counterelite and risked their lives and futures by demonstrating against the regime, all in the name of an abstract political freedom that would not have altered their life chances by very much? I suspect depressingly few.

[110] Thompson (fn. 16).

[111] For a good summary and evaluation of this literature, see Linda Cook, *The Soviet Social Contract and Why It Failed: Welfare Policy and Workers' Politics from Brezhnev to Yeltsin* (Cambridge: Harvard University Press, 1993).

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leaders, little could be done to change economic structures or industrial relations without the risk of open rebellion. For this reason, despite its formidable coercive capacities and unsurpassed surveillance apparatus, the GDR was a classically weak state.

Does the East German case discussed here offer a good basis to refute what I have called the "Whig" explanation of 1989? Partially, but not entirely. After all, everyday resistance did not and indeed was never intended to make the situation "go critical," which lends indirect credibility to the argument that political entrepreneurship is necessary for everyday resistance to be transformed into collective action. My evaluation of what were potentially regime-destroying strikes and protests in June 1953, however, suggests that political entrepreneurship is not always necessary for collective action in communist contexts. We should, therefore, not feel compelled to play up its role in 1989. Naturally, a host of other, historically more proximate factors must also be considered in order to explain why people mobilized the way they did in the fall of 1989. Any explanation of 1989, however, must account not only for mobilization in the final days, but also for the policy standoffs and state failures that made mobilization seem the sensible thing to do.

The approach taken here does not so much invalidate the civil society and mobilizational models, as it accounts for history that these models leave out—the long-term creeping immobilization of regime capacity to formulate and implement effective economic policies as a consequence of nonpolitical everyday forms of resistance by working people.[112] To be sure, the rise of articulate counterelites, Gorbachev's signaling from Moscow, and the decrease in the risk of intervention from abroad cannot be left out of any serious account of 1989. The Monday demonstrations in Leipzig, the mass rallies in Berlin, and the images of Christa Wolf, Stephan Heym, and other intellectuals addressing their fellow citizens all deserve a place in the historiography of the period.[113] Whether one wishes, however, to write the history of 1989 as *essentially* the culmination of overt dissidence and mass mobilization, and then search the historical record for antecedents supporting this interpretation, is another question. The approach offered here

[112] Tim Mason makes a similar argument for Nazi Germany. By 1939 the working class had the Nazi regime so paralyzed that the only way to break the back of everyday resistance and thus reimpose labor discipline was to go to war. Mason, *Social Policy in the Third Reich* (Providence, R.I.: Berg, 1993), 275–331. Extrapolating Mason's analysis to the Soviet empire in Eastern Europe (and the Soviet Union itself), one might argue that the only possible route to imperial salvation would have been a military adventure of some sort in Western Europe or China.

[113] Susanne Lohmann, "Dynamics of Informational Cascades: The Monday Demonstrations in Leipzig, East Germany, 1989–91," *World Politics* 47 (October 1994).

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suggests that we shift our attention away from the more obvious dramatis personae of history and back to the less obvious, away from the powerful and back to the powerless, and, finally, away from the drama of political development and back to the everyday acts of resistance that immobilized the regime.

Such a shift may be helpful not only to explain the long-term sources of communist political instability but also to account for the dynamics of politics after 1989, such as the renewed strength of communist parties throughout Eastern Europe. Rather than explaining the return of the communists and difficulties in the transition as a by-product of civil society's weakness, five years after claiming that communism fell because of the same civil society's strength, an alternative analysis would point to the moral shock of confronting for the first time the genuine commodification of such realms as housing, basic necessities, health care and the like, as well as early capitalist patterns of social stratification. As the above pages indicate, moral economies change very slowly, often lasting far longer than the antecedent conditions that produce them in the first place. Egalitarian sentiments persisted in East Germany, and indeed were catered to by the regime, long after the dire conditions that produced them in the immediate aftermath of the Second World War. Communist parties may not have succeeded in decreasing the historical disparity in income between Eastern and Western Europe, but they did succeed in radically altering the social structures and attitudes of the people in the countries where they ruled. It is these social structures and sentiments that the liberal states of Eastern Europe must confront today.[114]

[114] Survey evidence, for example, suggests that East Europeans continue to be more egalitarian than their Western counterparts and expect a larger role for the state in the economy. James P. McGregor, "Value Structures in a Developed Socialist System: The Case of Czechoslovakia," *Comparative Politics* 23 (June 1991), 181–99; Robert Rohrshneider, "Report from the Laboratory: The Influence of Institutions on Political Elites' Democratic Values in Germany," *American Political Science Review* 88 (March 1994), 927–41.

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Review Article

GOVERNING CHINA'S TRANSITION TO THE MARKET
Institutional Incentives, Politicians' Choices, and Unintended Outcomes

By DALI L. YANG*

Barry Naughton. *Growing Out of the Plan: Chinese Economic Reform, 1978–1993*. Cambridge and New York: Cambridge University Press, 1995, 379 pp.

Susan Shirk. *The Political Logic of Economic Reform in China*. Berkeley: University of California Press, 1993, 399 pp.

HOW times change. Scarcely two decades after Mao's death, China has not only largely navigated the turbulent journey to a market economy without undergoing a "big bang" or shock therapy but has also sustained an enviable economic growth record during the transition. Such apparent success attracts attention, as the growing number of books chronicling China's rise or reawakening attest.[1] Once the inspiration for radical Western scholars and activists seeking alternatives to capitalism, China has metamorphosed into a model for reforming and dismantling the command economy.[2]

Conventional wisdom tells us that the odds of a communist economy

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[1] See, e.g., Nicholas Kristof and Sheryl WuDunn, *China Wakes: The Struggle for the Soul of a Rising Power* (New York: Times Books, 1994); William Overholt, *The Rise of China: How Economic Reform Is Creating a New Superpower* (New York: W. W. Norton, 1993).

[2] Dwight Perkins, "Completing China's Move to the Market," *Journal of Economic Perspectives* 8 (Spring 1994); Gary Jefferson, Kang Chen, and I. Singh, "Lessons from China's Economic Reform," *Journal of Comparative Economics* 16 (June 1992); John McMillan and Barry Naughton, "How to Reform a Planned Economy: Lessons from China," *Oxford Review of Economic Policy*, 8, no. 1 (1992); Fan Gang, "Incremental Changes and Dual-track Transition: Understanding the Case of China," *Economic Policy* 9 (December 1994).

World Politics 48 (April 1996), 424–52

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making a gradual transition to a market economy are as slim as those of persuading a leopard to change its spots. On the one hand, communist economic institutions constitute a coherent whole for central planning and are maladaptive to changing circumstances; on the other hand, communist politicians who benefit from existing institutional arrangements would be expected to put up strong resistance to the introduction of market-based transactions that undermine their rent-seeking activities.[3] These twin obstacles against innovation make the China case especially interesting both theoretically and practically. How has China managed to transform itself into a market economy without going into economic free fall, as occurred in other former communist countries? What accounts for the pattern of reforms in China? What are the costs and benefits of the Chinese approach to economic reform?

The two magnificently researched volumes by Barry Naughton and Susan Shirk, colleagues at the Graduate School of International Relations and Pacific Studies at the University of California, San Diego, offer intriguing and frequently provocative answers to these questions by focusing on reforms in Chinese industry, finance, and macroeconomic policy.[4] Both regard Chinese policymakers as rational actors, although Naughton the economist considers them only "weakly rational" (p. 23). He also sees an economic logic to the progression of reforms in China, whereas Shirk argues that a distinctly political logic has predominated. Although both studies focus on China, they are also broadly comparative, in particular with regard to reforms in other formerly communist economies. Their theoretical sophistication and comparative perspective mark the maturing of Chinese studies in social science.

The Political Logic of Economic Reform: Does Succession Competition Explain the Pattern of Reform Policies?

In the most ambitious effort yet to apply the rational choice approach to the study of Chinese politics, Shirk argues that there is a political

[3] For a neoclassical perspective on rent seeking, see Anne O. Krueger, "The Political Economy of the Rent-Seeking Society," *American Economic Review* 64 (June 1974). For one widely reported proposal to surmount the problem, see Jan Winiecki, "Buying Out Property Rights to the Economy from the Ruling Stratum: The Case of Soviet-Type States," *International Review of Law and Economics* 9 (June 1989). Winiecki's other works have emphasized elite resistance to reforms.

[4] Whereas Naughton makes the rise of nonstate enterprises a crucial component of his analysis, Shirk (p. 20) chooses to concentrate on state-owned enterprises, on the grounds that they generate a

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logic to the Chinese pattern of reform that links succession competition to particularistic reform policies. She constructs her analytical framework from a simple but fundamental insight: top Chinese leaders (including the Communist Party general secretary, Political Bureau members, or Political Bureau standing committee members) are not popularly elected by voters but are chosen by what she terms a *selectorate*—a phrase borrowed from British parliamentary politics—that they have a hand in appointing.[5] According to the Communist Party (CCP) constitution, the selectorate should be the CCP Central Committee. In reality the preeminent leader (Deng Xiaoping for the period under study), top military officers, and a significant but ever-decreasing number of revolutionary party elders have also exercised much influence over major appointments and policy-making and thus also belong to the selectorate even when they are not members of the Central Committee. Owing to the lack of clear institutional rules about leadership selection and succession, top Chinese leaders and contenders for these positions are condemned to incessant jockeying for position. Throughout the post-Mao era, the struggle for power has also been intensified because "the top leader is [either] conspicuously weak (as in the case of Hua Guofeng [Mao's immediate successor]) or elderly (as in the case of Deng Xiaoping)" (p. 71).

Once we step beyond the general framework described in the last paragraph, however, the analytical terrain turns slippery. Not only is the choice rule for leadership selection unclear,[6] but given the typically informal nature of Chinese elite politics, the boundary and composition of the selectorate are not easily defined. While the relative influence of the selectors is difficult to fathom, Shirk *assumes* that numbers in the selectorate make a difference and repeatedly reminds us that the largest blocs within the selectorate, estimated at close to five hundred people, are provincial party and government officials, central party and government officials, and military leaders. As rational politicians responding to career incentives, Chinese policymakers competing for the top positions must play to the selectorate and especially to the largest blocs

large share of China's output value and financial revenue. Neither pays much attention to the more successful reforms in agriculture and foreign trade, although Shirk has since extended her study to foreign trade; see Shirk, *How China Opened Its Door: The Political Success of the PRC's Foreign Trade and Investment Reforms* (Washington, D.C.: Brookings Institution, 1994).

[5] The term "political bureau" is used here instead of "politburo" because the former is the standard translation used by the Chinese since the 1980s.

[6] Shirk claims that the selection of top leaders follows certain formal as well as tacit rules and norms but admits at the end of the book that much remains to be learned about the choice rule by which the selectorate operates (p. 339).

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within it. Specifically, Shirk contends that, because of the heavy presence of provincial party and government officials as well as central party and government officials in the selectorate, "party politicians in Beijing and, indeed, at every level of the system had a political incentive to generate political support for themselves by pushing policies that took the form of particularistic contracting" such as central-provincial fiscal contracts and profit contracting in state-owned enterprises (p. 337).

By focusing on institutional incentives for political behavior, Shirk thus seeks to disabuse us of the journalistic preoccupation with a few leading personalities (such as Deng Xiaoping) in China without denying that party elders such as Deng have had significant influence over reform policy-making.[7] In a field not generally known for analytical rigor, Shirk's book stands out for its bold and specific propositions. Moreover, it tests the propositions or hypotheses empirically through a series of well-chosen and well-developed case studies covering fiscal decentralization and industrial reforms. By subjecting her hypotheses to empirical verification, she avoids one of the most common pitfalls in the application of rational choice models.[8] The obvious question for the reviewer is whether in fact the empirical cases sustain the hypothesis. The rest of this section examines the purported linkage between succession competition and particularistic reforms (hereafter the *succession competition thesis*).

Fiscal Decentralization versus Rationalization

Shirk regards fiscal decentralization that enhances provincial financial autonomy through particularistic revenue contracts negotiated between the center and each provincial government as "the cornerstone" of party leaders' political strategy to garner support for reform among provincial elites, who in turn build patronage networks of their own. Decentralization made these officials into a political counterweight to the central bureaucracy (p. 149). Along with decentralization, the proportion of provincial leaders in the Central Committee was also increased by Deng Xiaoping and his allies to become the largest bloc (43 percent in 1987) (p. 150).[9]

[7] It should be pointed out that Shirk is aware that her approach has limitations. In the conclusion (p. 339), she frankly admits that "we are still a long way from a genuine model of communist political institutions and policy-making. In studying the Chinese reform, I often found myself unable to explain changes in policies by the institutional context and fell back on ad hoc explanations instead."

[8] Donald P. Green and Ian Shapiro, *Pathologies of Rational Choice Theory: A Critique of Applications in Political Science* (New Haven: Yale University Press, 1994).

[9] Shirk notes that the percentage of provincial officials *plus* regional military officers was more than 50% of the total Central Committee membership in 1987. It should also be noted, however, that

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Such a system tends to be self-perpetuating through positive feedback: as the influence of provincial officials in the center grows with decentralization, central leaders will also find their incentives to continue particularistic contracting increasing, in order to maintain and cultivate a base of support among provincial officials. Indeed, Shirk asserts that this process made it "unthinkable for ambitious central politicians such as Hu Yaobang, Zhao Ziyang, and even Li Peng to attempt to roll back the reforms" (p. 196). When central leaders did seek to recentralize the fiscal system, they were met by fierce opposition from provincial officials who in fact "were able to win increasingly generous revenue-sharing contract terms" (p. 152).

How does Shirk's account relate to factual evidence? To begin with, the initial experiments with fiscal contracting were started during the interregnum of Hua Guofeng, Mao's immediate successor, who presided over an effort to recentralize the economy. More important, the proposal for popularizing fiscal contracting was premised more on bureaucratic rationality than on political machination. It was the Ministry of Finance, the core of the central apparatus, that proposed the move in order to "stem the progressive deterioration of central revenues and force localities to share financial risk with the center" (p. 163).[10] Nevertheless, the policy accorded with Shirk's explanation that Hua, who was politically threatened by Deng and his allies, had a political interest in courting provincial elites. Moreover, Shirk writes, after Deng defeated Hua, he "embraced the policy as a way to consolidate his authority and build support for the reform drive" (p. 165). The same was also true of Deng's two right-hand men, Hu Yaobang and Zhao Ziyang. Shirk's chapter on decentralization concludes with the case of Premier Li Peng's efforts to recentralize the fiscal system in 1987–88 and 1989–90. These were periods of conservative resurgence, particularly after the 1989 crackdown. In both cases, however, Li chose to retain fiscal contracting in order, Shirk believes, "to keep the support of at least some of these [provincial] officials and prevent them from siding with one of his political rivals" (p. 195). Thus the empirical evidence up to 1990 seems consistent with the succession competition hypothesis. For Shirk, the reason party leaders did not attempt to impose a thoroughgoing fiscal reform over the objections of provincial officials was

counting only provincial party secretaries, while the percentage for 1987 (38%) was higher than in 1982 (34%), both were actually lower than in 1977 (43%). Moreover, the Central Committee should not be confused with the selectorate; the CC is only part of the selectorate and it is not clear what proportion of the selectorate these officials constitute.

[10] Shirk uses the word "surprisingly" to describe this move.

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that the latter constituted a crucial bloc within the selectorate (p. 177). "During a period of succession competition, to flout the wishes of provincial politicians would have been political suicide even for a conservative leader whose primary base of support was the central bureaucracy" (p. 154).

Unfortunately for Shirk's thesis, history did not end in 1990. By the time her book appeared, a new round of fiscal reforms had been launched. Central leaders including President Jiang Zemin, Premier Li Peng, and Vice Premier Zhu Rongji worked in concert in late 1993 to push through sweeping reforms for rationalizing the fiscal structure, by replacing particularistic fiscal contracting with revenue sharing under separate tax systems for the center and the localities. The reforms were also intended to shore up the fiscal capacity of the central government, whose share of total revenue would rise from about 38 percent in 1993 to as high as 60 percent. Meanwhile, a separate Budget Law enacted in March 1994 requires local government to achieve a balanced budget and conduct conservative fiscal policies.[11]

By 1993 the dynamics of the political succession struggle in China had presumably intensified as Deng Xiaoping and his cohort inexorably aged and as their health further deteriorated.[12] Moreover, provincial officials presumably remained strong within the Central Committee. Therefore, following the succession competition thesis, one would have predicted that China's central leaders, especially President and General Secretary Jiang Zemin, would at least have retained the particularistic fiscal arrangements but perhaps even have distributed more pork barrels of their own. Yet instead of vying with each other to dole out more pork, as the succession competition thesis would predict, central leaders pushed hard to rationalize the fiscal system in spite of continuing opposition from a significant number of provincial leaders. Indeed, the impending political succession appears to have imparted a sense of urgency to central leaders about the need to rebuild the fiscal foundations for the central government. Without denying the argument that decentralization helped to mobilize provincial support for the reform drive, the adoption and implementation of sweeping fiscal and tax reforms in 1993–94 cast doubt on the validity of the succession competition thesis.

[11] Wanda Tseng, Hoe Ee Khor, Kalpana Kochhar, Dubravko Mihaljek, and David Burton, *Economic Reform in China: A New Phase* (Washington, D.C.: International Monetary Fund, 1994), 34–35. The conservative policies for localities stipulate that the center will no longer make transfers to cover local fiscal deficits. Neither can the local deficits be financed with bond issues or bank borrowing.

[12] Deng turned eighty-nine in 1993. The life expectancy at birth in China as of 1991 was sixty-nine. A number of important party elders, including Chen Yun, Wang Zhen, Deng Yingchao, and Yao Yilin, died in recent years.

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The 1993 fiscal rationalization shows that central leaders did not follow the logic delineated by Shirk but instead responded to a perceived fiscal crisis of the center. As long as the fiscal situation seemed to be under control,[13] central leaders chose not to expend much administrative energy and political capital to revamp the system; rather, they acquiesced to the demands of the various vested interests that benefited from fiscal decentralization. When the center's fiscal problems were perceived to have assumed crisis proportions, especially in the context of the collapse of the Soviet Union and of China's own problems of political legitimacy, then central leaders mustered their strength to reshape the fiscal structure.[14] The strength of Shirk's book lies in its identification of the myriad interests that benefited from decentralization; ironically, however, her framework leaves national politicians with too little room for choice.

Particularism and the Pattern of Fiscal Benefits

While the 1993 fiscal rationalization case weakens the robustness of the succession competition thesis, it is nevertheless possible that this mechanism did play a significant role in the 1980s, when Hu Yaobang, Zhao Ziyang, and Li Peng were the major contenders for succession. If this is true, then one would expect not only that particularistic contracting should be retained as a form of policy but also that it should exhibit certain patterns in provincial fiscal distribution.[15]

Shirk recognizes the latter possibility in passing, pointing out that fiscal decentralization "did not make the local governments as a whole better off" and that economically less developed provinces and national minority provinces that received central subsidies opposed fiscal decentralization (pp. 151, 165). Elsewhere (p. 171) she concedes that in the case of the three metropolises (Shanghai, Beijing, and Tianjin), the center's revenue concerns dominated political considerations; as a result, the three were subjected to higher rates of revenue transfer to the center than were other provinces, and they were "clearly dissatisfied"

[13] Shirk points out that through the 1980s the Ministry of Finance either supported fiscal contracting or was lukewarm about pushing for sweeping changes in the fiscal system. It is thus hard to imagine that central leaders would want to push for drastic reforms.

[14] This argument is made in Dali L. Yang, "Reform and the Restructuring of Central-Local Relations," in David S. G. Goodman and Gerald Segal, eds., *China Deconstructs: Politics, Trade and Regionalism* (London and New York: Routledge, 1994).

[15] This extension of the original proposition is designed to maximize leverage and test other observable implications of the hypothesis. For discussion of these themes, see Gary King, Robert Keohane, and Sidney Verba, *Designing Social Inquiry: Scientific Inference in Qualitative Research* (Princeton: Princeton University Press, 1994).

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with their fiscal arrangements.[16] Nonetheless, even though a significant number of provincial units were unhappy with fiscal decentralization, Shirk concludes that owing to the patronage opportunities created by fiscal contracting, "local officials had no interest in abandoning contracting for either a return to fiscal centralization or some other method that separated central and local taxes" (p. 152).

By the logic of the succession competition thesis, one would generally expect those provinces that had more representation on the Central Committee to derive more fiscal benefits from the center.[17] All things being equal, a province with two members on the Central Committee was more worthy of attention from a leader seeking support than a single-member province. Similarly, a province that boasted a Political Bureau member was more worthy of attention than one that had only a Central Committee member. To test this proposition, indices of provincial Central Committee representation are compiled and regressed against data on provincial revenue balance for 1987.[18] Data for 1987 are used because Shirk reckons it to be a year of strong provincial influence, noted for increased provincial representation on the Central Committee, as well as for managing to maintain particularistic fiscal contracting in the face of central efforts to roll it back.

The regression result (without controlling variables) shows a statistically significant relationship for 1987, but the sign is exactly the opposite of that predicted by the succession competition thesis.[19] In other words, in 1987 those provincial units that enjoyed greater representation on the Central Committee had to remit more money to the center. On closer inspection, the statistical significance is due to the case of Shanghai as an outlier; Shanghai is well known to have consistently chafed under restrictions imposed by the center.[20] Removing Shanghai from

[16] On p. 171 Shirk says that the three metropolises were "the only" provincial units dissatisfied, but in light of the other comments cited here, this was clearly not the case.

[17] Shirk (p. 151) recognizes the differential impact of fiscal decentralization on the provinces by saying that "this fiscal reform formula did not make the local governments as a whole better off."

[18] Revenue balance (RB) = revenue − expenditure. If RB > 0, then the province sent money to the center; if RB < 0, then the province received a central subsidy. The index of provincial representation on the Central Committee is compiled by assigning a different value to each level. These values range from 1 for a Central Committee alternate member to 5 for a member of the Political Bureau Standing Committee. I am grateful to Zhiyue Bo of Roosevelt University for supplying me with these numbers from a database he has compiled. The figures for population and level of economic development come from State Statistical Bureau, *Zhongguo tongji nianjian* (Statistical yearbook of China) (Beijing: Zhongguo tongji chubanshe, 1988–89).

[19] N = 29, F(1, 27) = 4.73, Coefficient = 5.800625, Standard Error = 2.666862, t = 2.175, significant at the 0.05 level, Adjusted R^2 = 0.1176.

[20] Bruce Jacobs and Lijian Hong, "Shanghai and the Lower Yangzi Valley," in Goodman and Segal (fn. 14), 224–52.

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the sample, the relationship ceases to be statistically significant (though the sign of the regression remains the opposite of the prediction).

In performing the same regression again, this time controlling for level of economic development and provincial population size, there was again no statistically significant relationship between representation on the Central Committee and provincial fiscal balance. But both control variables show statistically significant relationships with the dependent variable (provincial revenue balance). The adjusted R^2 (0.7806) indicates that level of economic development and population size account for just above 78 percent of the variations in China's provincial fiscal balances for 1987. In other words, the pattern of provincial fiscal revenue balances reflects economic factors rather than political considerations.

Succession Competition and the Pattern of Industrial Reforms

Not only does the case of fiscal decentralization fail to sustain the succession competition thesis, but the pattern of industrial reforms, which Shirk deals with in four separate chapters, is also inconclusive. As in the case of fiscal reforms, the central issue in industrial reform is the tension between rationalization and particularistic contracting.

Shirk begins her argument with the case of industrial reform takeoff (1978–81), a period (up to fall 1980) noted for the rivalry between Hua Guofeng, Mao's successor, and the pragmatists led by Deng Xiaoping and Chen Yun. As Shirk sees it, Hua sought to recentralize industrial finance and administrative authority in the aftermath of the Cultural Revolution, whereas Deng and Chen adopted "a strategy of outbidding Hua for the support of industrial and local officials with reformist giveaways" (p. 208). In late 1978 Deng criticized the overconcentration of power in the economy and called for expanding the decision-making powers of economic units in order to stimulate their initiative.[21] In response to this theme, the State Economic Commission picked up a small-scale enterprise autonomy experiment in Sichuan and authorized provinces and cities to experiment with expanded enterprise autonomy, including profit retention, thereby generating local interest in industrial reform. Enterprises and local governments in fact eagerly embraced the experiment, and by 1980 the practice had spread to 16 percent of the

[21] Deng Xiaoping, "Emancipate the Mind, Seek Truth from Facts and Unite as One in Looking to the Future (December 13, 1978)," in *Selected Works of Deng Xiaoping (1975–1982)* (Beijing: Foreign Languages Press, 1984), 157.

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state-owned enterprises. By early 1982 most enterprises had adopted profit contracting.[22]

Shirk asserts that by late 1980 "Deng had defeated Hua by mobilizing support behind his platform of industrial enterprise reform" (p. 197). Yet the platform's real contribution to the political dominance of the Deng coalition is difficult to assess. The industrial reform platform probably contributed to Deng's rise to preeminence, but it was surely not the decisive factor behind Deng's ascension to paramount leadership. It is perhaps more apt to agree with Naughton that the primary reason Hua had to cede economic power to the Deng-Chen coalition was that his grandiose ten-year plan (which ironically also incorporated elements of Deng's 1975 documents) was built on thin air and had collapsed by the end of 1978, owing to incompetent planning and sheer bad luck (Naughton, 70–74). As a result, economic governance was transferred to the purview of the seasoned economic troubleshooter Chen Yun. Once Hua lost the reins of economic power, Hua the political upstart also lost the primary policy arena in which he might have been able to build up his own shaky legitimacy to compare to the revolutionary prestige that Deng and Chen had enjoyed.[23]

There was no doubt that enterprise profit contracting and other decentralizing measures stimulated local initiative. On the basis of the case of economic readjustment launched by Chen Yun to deal with the consequences of Hua's economic program, Shirk argues that the readjustment program that emphasized central control and moderate growth was slow to get started and short-lived because of "the weight in the selectorate of local and industrial ministry officials who were benefiting from decentralization" (p. 197).

Contrary to the succession competition thesis, however, Premier Zhao Ziyang chose not to play this game in 1982–83, thereby highlighting the difficulties of applying the institutional rational choice approach when the parameters for choice are not clearly delineated. At the time General Secretary Hu Yaobang and Premier Zhao Ziyang were regarded as the two most likely successors to Deng. Yet they disagreed sharply over how to reform China's state enterprises. Hu favored

[22] Shirk, 202; Barry Naughton, "False Starts and Second Wind: Financial Reforms in China's Industrial System," in Elizabeth Perry and Christine Wong, eds., *The Political Economy of Reform in Post-Mao China* (Cambridge: Harvard University Council on East Asian Studies, 1985).

[23] Yu Jian, *Zhonghua renmin gongheguo lishi jishi: gaige yangfan (1976–1984)* (A historical record of the People's Republic of China: Reform sets sail [1976–1984]) (Beijing: Hongqi chubanshe, 1994), 124–25. Central leaders criticizing Hua also noted that Hua had primary responsibility for the economic errors but was not the only culpable person.

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enterprise profit contracting, whereas Zhao, in contrast to the expectations of the succession competition thesis, pushed for replacing enterprise profit contracting with a uniform tax system, commonly known as the tax-for-profit approach. Instead of outbidding Hu to offer particularistic giveaways for provincial support, Zhao's State Council decided in favor of tax-for-profit in 1983; implementation followed, albeit in drastically watered-down form.

Shirk admits that the adoption of the tax-for-profit policy was contrary to prediction, in fact, "surprising in that fiscal conservatism and technocratic caution appeared to prevail over the political logic of distributing benefits to selected localities and enterprises" (p. 222). Shirk explains Zhao's policy choice in terms of the economic context (inflation) and especially Zhao's "interests in gaining credibility with central bureaucrats [in the Ministry of Finance] and conservative party elders who were powerful groups within the selectorate" (p. 244).[24] While Shirk earlier pointed to the weight in the selectorate of local and industrial ministry officials who benefited from decentralization (p. 197), she now holds that "support for profit-contracting within the selectorate, from the provincial officials and industrial ministry officials in the Central Committee who would have benefited from it, was not yet firm" (p. 222). By arguing that local and ministerial support had "weight" but "was not yet firm," Shirk was able to conclude that Zhao, the newcomer to Beijing, rationally chose to side with the conservative elders (see especially p. 251) in making the initial decision but then had to dilute implementation of the decision on account of the strength of local and ministerial interests.

However one explains Zhao's position, this case again highlights the issue of a politician's choice vis-à-vis institutional constraints. Had Zhao, as a former provincial leader, chosen profit contracting, it would have been equally rationalizable in hindsight, at least from the perspective of maximizing support in the selectorate. This is because the profit-contracting approach not only could have solidified support for Zhao from many fellow locals in the Central Committee, but also could probably have won him new and important support from officials in

[24] Shirk (pp. 225–26) draws on her interviews to suggest that the strength of the conservatives influenced Deng Xiaoping to back Zhao's tax-for-profit approach. Yet there is evidence indicating that Deng, like Hu, promoted the paradigm of contracting outside agriculture once the rural reforms had been deemed successful in the early 1980s. On June 18, 1983, Deng said that, while industry and agriculture differed, "the basic principle [of reform] should be based on the responsibility system; and this must be affirmed." *Deng Xiaoping wenxuan* (Selected writings of Deng Xiaoping) (Beijing: Renmin chubanshe, 1993), 3:29, also 78, 81–82.

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various industrial ministries and the State Economic Commission.[25] The main difference between the two options is that had Zhao chosen profit contracting, he would probably have lost some support from such conservative elders as Chen Yun, who was not just an average selector but probably had veto power at this time, an issue that is not adequately accounted for in Shirk's analytical framework relating the selectorate to policy choice. Another possibility is that Zhao simply decided that tax-for-profit was the best economic option available and adopted it to improve the country's economic performance, prove his competence in economic management, and thus improve his chances for being the eventual successor (p. 223). In any event, this case is disconfirming for the succession competition thesis.

Shirk takes us next to the revival of profit contracting under Zhao Ziyang in the aftermath of implementation of a severely diluted tax-for-profit plan between 1983 and 1986. She claims that "as soon as Hu Yaobang was eliminated from the succession and the contest was reframed between Zhao the reformist and Li Peng the conservative, Zhao immediately switched positions to advocate contracting and abandon standardization" (p. 281). In fact, as Joseph Fewsmith has pointed out, Zhao switched to the profit-contracting approach in November 1986, nearly two months before Hu was forced to resign in January 1987.[26] Nevertheless, assuming that—in contrast to 1982–83—local and municipal officials were now firmly pushing for profit contracting, it was still possible that Zhao had switched this position in order to cultivate support from provincial and ministerial leaders regardless of whether his competitor in the succession game was Hu Yaobang or Li Peng.

Yet if Zhao was indeed switching to profit contracting to play the succession game, he was, in light of the politics of Hu's ouster, placing the wrong political bet. First, when Hu Yaobang was forced to resign, a major charge (the third of six) against him was that he had overemphasized demand stimulation, leading to undue growth acceleration and causing the economy to go out of control.[27] Since enterprise profit contracting was known to stimulate economic expansion, Zhao's position

[25] Shirk writes: "As a longtime provincial leader newly arrived in the capital, Zhao presumably already had the support of many fellow locals in the Central Committee, although they did not constitute a personal following comparable to Hu's" (p. 222).

[26] Joseph Fewsmith, *Dilemmas of Reform in China: Political Conflict and Economic Debate* (Armonk, N.Y.: M. E. Sharpe, 1994), 234 n. 34. On Hu's resignation, see Richard Baum, *Burying Mao: Chinese Politics in the Age of Deng Xiaoping* (Princeton: Princeton University Press, 1994), 205–7.

[27] Baum (fn. 26), 207.

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switch was like stoking the economic fires when party elders favored a more moderate pace of economic growth. Second, since Hu Yaobang was forced out by party elders, Zhao should know very well who possessed ultimate power in Chinese politics at this time, whatever the alleged strength or weight of provincial and ministerial officials in the selectorate. Concentrating on the cultivation of provincial and ministerial support at a time when party elders held de facto supervoting privileges would not and in fact did not help Zhao maintain his power in the summer of 1989.[28] If Hu and Zhao really did compete to promote particularistic policies with a view to cultivating support in the selectorate, the most charitable thing one can say about them politically is that they identified the rising potential of local and ministerial officials but bet prematurely on that potential. Given what one knows about the influence of party elders on top appointments, any succession contender playing to the selectorate will have to play to the elders first. In other words, while Hu and Zhao were committed reformers, they were hardly astute politicians as far as political survival was concerned.[29] Either they did not fully appreciate the logic as identified by Shirk, or the logic as presently framed does not capture the reality of Chinese politics well.

Thus the three policy episodes on profit contracting vis-à-vis tax-for-profit show little systematic relationship between succession competition and profit contracting. Our examination suggests that the 1987 case seems to fit the succession competition thesis but that two others do not. Moreover, as in the case of fiscal contracting, a decision has been made by the current leaders in China to end enterprise profit contracting in 1995, providing another powerful case against the succession competition thesis. Instead of making each enterprise sign contracts with the state, China's state enterprises will gradually be turned into tax-paying modern firms.[30] Surely China's current leaders want to survive the death of Deng, but their choices in fiscal, tax, and enterprise reforms since 1993 suggest that they are consolidating their power not by promoting more particularistic contracting, as the succession competition thesis predicts, but by ending it.

[28] Ibid., 208. Baum points out that Party Central Document no. 3 (1987), which justified the ouster of Hu Yaobang, also "provided the rationale for allowing retired party elders to override younger leaders in time of crisis."

[29] An alternative explanation is that both Hu and Zhao were doing Deng's bidding in promoting reforms. Both were sacrificed by Deng and blamed for problems in reform.

[30] *China Daily*, June 20, 1995, p. 4.

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The Power of Shirk's Approach

I have thus far dwelled on the succession competition thesis. The above examination of developments in both fiscal decentralization and state enterprise reforms suggests that the thesis cannot be sustained empirically. The fundamental reason for this empirical failure is due not to inherent flaws in the institutional rational choice approach but to the author's one-sided emphasis on the influence of provincial and ministerial officials in a selectorate that has also seen the dramatic demonstration of power and influence by party elders, not to mention other groups such as the military. The power and influence of the party elders were not easily captured in terms of numbers in the selectorate. Likewise, the importance of the military goes far beyond sheer numbers. Shirk (p. 76) in fact quotes Joffe favorably to acknowledge that the military is an indispensable member of any winning coalition and notes that both Li Peng and Jiang Zemin enthusiastically endorsed large increases in the military budget following the 1989 crackdown.[31] It is obvious that specification of the causal mechanisms leading from the selectorate as an institution to policy choice cannot simply be predicated on the share, as alleged "blocs," of provincial and ministerial officials in the selectorate but must also factor in how the "votes" are manipulated and counted in the selection process.

If succession contenders seek to maximize political power without exposing themselves to too much downside risk (in the parlance of investment, this is the risk-adjusted return), then it appears that they may seek to construct winning coalitions of various compositions depending on the composition and vote-weighing mechanism of the selectorate, leading to variations in policy outcomes. While cultivating the support of provincial and ministerial officials is one plausible choice, it is also possible—though the choice is rarely so starkly posed—that a succession contender may want to rely on support from military and party elders and only some provincial and ministerial officials to stay in power, which partly accounts for the current leaders' determination and ability to revamp central-local relations in favor of the center and end state enterprise profit contracting. Indeed, making particularistic policy the litmus test of the institutional incentives operating in the Chinese political system unduly narrows the range of issues of concern to Chinese policymakers. Chinese policymakers are not one-dimensional pol-

[31] Ellis Joffe, *The Chinese Army after Mao* (London: Weidenfeld and Nicolson, 1987).

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icy hedgehogs interested only in economic reforms but rather are also concerned about social stability and public order, defense, foreign policy, ideology, party organization, and so on, as the catalog of Hu Yaobang's alleged mistakes attests. Economic policy is merely one, albeit probably the most important one, of a whole spectrum of policies on which a potential leader should build his or her political ambition and consolidate political power. There may be trade-offs between different policy domains, and a rational politician concerned about political power and survival is expected to fashion a set of policies across these domains. In other words, this is the world of multiple equilibria, with various possible combinations of policy choices.

Finally, even if the linkages between institutional incentives and policy choices are specified, there will still be room for political leaders to make independent choices. Unfortunately, Shirk's bold thesis on the policy implications of succession competition not only suffers from the underspecification of the causal paths leading from institutions to policy but also leaves little room for independent choice by politicians. Succession competition does not precommit the contenders to one particular reform policy and certainly not to particularistic contracting. In sum, once a major institutional change is introduced, it tends to persist until a crisis or a perceived crisis prompts politicians to fight and reorient the institutional setup. As a result, major realignments of policies cannot simply be predicted from a calculus of vested interests. There is an inherently contingent element to this process arising from the dynamic uncertainties of political struggle between national politicians and vested interests in an evolving economic environment.[32]

Yet while Shirk constructs her analysis around an elaboration and empirical examination of the succession competition thesis, the value of her book does not rely on the validity of that thesis alone. In fact, the focus on the succession competition thesis diverts attention from the book's great strength—identifying the vested interests involved in tilting, twisting, resisting, delaying, and subverting various policy packages during the reform era. The extraordinarily rich materials in Shirk's study, drawn from extensive interviews with Chinese officials and written sources, shed much light on the ongoing policy struggle between national politicians and parochial (bureaucratic) interests.[33] Shirk offers

[32] For comparative perspectives, see Bernard Silberman, *Cages of Reason: The Rise of the Rational State in France, Japan, the United States, and Great Britain* (Chicago: University of Chicago Press, 1993); Sven Steinmo, Kathleen Thelen, and Frank Longstreth, eds., *Structuring Institutions: Historical Institutionalism in Comparative Analysis* (Cambridge: Cambridge University Press, 1992).

[33] Earlier and important contributions to the study of bureaucratic decision making in China include Kenneth Lieberthal and Michel Oksenberg, *Policy Making in China: Leaders, Structures, and*

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a masterful analysis of why the adoption of tax-for-profit reforms in state enterprises in the early 1980s turned out to be far less of a victory than had originally been anticipated (chap. 12). Indeed, implementation of the tax-for-profit policy was so severely diluted and distorted by vested interests that it achieved little of its intended bite.

The fact that Chinese politics has stubbornly refused to conform to the predictions of the succession competition thesis should not, however, be construed as obviating the need for further efforts at applying the institutional rational choice approach to the study of Chinese politics. Rather, as the patriarchs die off and as Chinese politics becomes more institutionalized, the type of institutional dynamics Shirk has sought to uncover is likely to become more significant than before. Shirk, then, has developed a productive approach to the study of Chinese politics, one that should attract a new generation of graduate students. They, in turn, will set about mapping out the parameters and the rules of the game in these institutions, identifying in detail the composition and "voting" rule of the selectorate, and deducing and empirically testing the policy implications of these institutions for politicians governing and coping with a world of uncertainty.

The Economic Logic of Chinese Reform: The Making of Market Competition

Whereas Shirk seeks to uncover the enduring influence of political institutions on politicians' policy choices, Naughton is interested in explaining the pattern of actual economic reforms in China. In contrast to Shirk, he does not start with a deductive model or framework but, instead, reminds the reader that there is as yet no comprehensive narrative account of the Chinese reform process. He therefore sets out first to reconstruct a historically faithful account of that process (p. 5). Tedious though such a chronological account may occasionally be, it is essential to the task of explanation because Chinese reforms have been gradual, evolutionary, and path dependent.

Yet Naughton presents us with far more than a descriptive history of Chinese reforms. Combining analytical rigor with a rare grasp of the

Processes (Princeton: Princeton University Press, 1988); Kenneth Lieberthal and David Lampton, eds., *Bureaucracy, Politics, and Decision Making in Post-Mao China* (Berkeley: University of California Press, 1992); and David Bachman, *Bureaucracy, Economy, and Leadership in China* (Cambridge: Cambridge University Press, 1991). For an argument that there was less real bargaining over the interests involved, see Carol Lee Hamrin and Suisheng Zhao, eds., *Decision Making in Deng's China: Perspectives from Insiders* (Armonk, N.Y.: M. E. Sharpe, 1995), xxxv.

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historical context, he not only provides an excellent review of China's path of reform but also alerts us to the various other byways down which China's leaders have taken the reform process. While the official directions have frequently been bypassed or ignored, circumstance and luck have propelled the Chinese economy to the market. Policymakers neither anticipated nor could dictate the terms of the transition, their hands often being forced by conditions of economic crisis. He concludes that the reform pattern "was shaped more by economic conditions and the interaction between economics and politics than it was by ideology or politics" (p. 23).

Naughton's central message is that China's conversion to a market economy was not part of the plan at the start of the reforms. In fact, it was not until after the Tiananmen crisis that transition to a market economy became the explicit goal of economic reform. Nevertheless, through the 1980s Chinese planners gradually adopted a series of policy measures that froze the size of the plan and tolerated the emergence of a market track as well as the entry of new producers. This unleashed increasing competition on the market and allowed the Chinese economy to grow out of the plan. As an explanation of both China's conversion to the market and ultimately the sources of China's economic dynamism, Naughton's thesis of increasing market competition seems a more satisfying account than is Shirk's emphasis on particularism and vested interests.

The Initiation of Post-Mao Reforms

Because initial conditions matter for path-dependent processes, it is useful to consider the initiation of reforms.[34] This case not only illustrates Naughton's approach in combining economic and historical analyses but also casts doubt on the conventional argument linking the Cultural Revolution to the launching of reforms. According to this argument, which is widely accepted among both Chinese and Western scholars, the chaos and destruction caused by the Cultural Revolution over the 1966–76 period led to the initiation of reforms.

While the upheaval of the Cultural Revolution was undoubtedly of

[34] Path-dependent processes demand historical analysis of the causal chains that lead from the past to the present. In the words of Paul David, "It is sometimes not possible to uncover the logic (or illogic) of the world around us except by understanding how it got that way. A *path-dependent* sequence of economic changes is one in which important influences upon the eventual outcome can be exerted by temporally remote events, including happenings dominated by chance elements rather than systematic forces"; David "Understanding the Economics of QWERTY: The Necessity of History," in William N. Parker, ed., *Economic History and the Modern Economist* (Oxford: Blackwell, 1986), 30.

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great political import, its impact on the initiation of reforms has been poorly specified and substantiated. As far as the breakthrough in rural reform is concerned, it has been documented elsewhere that the key to the rise of rural reforms in China lies in the Great Leap Famine of 1959–61, the worst famine in human history, rather than in the Cultural Revolution. Cross-sectional data analyses informed by cognitive psychology suggest that the enthusiasm with which a province pursued rural reform in the late 1970s and early 1980s was in direct proportion to the pain it had experienced during the Great Leap Famine, which resulted directly from the push for people's communes during the Great Leap Forward (1958–61). Out of the ruins of the Great Leap Famine arose the incentives for rural institutional change, eventuating in rural decollectivization in the early 1980s, despite the fact that neither Hua Guofeng nor the Deng-Chen coalition had intended to dismantle the commune system.[35]

The legacy of the Cultural Revolution did not lead directly to market-oriented reforms in industry either. In fact, both Solinger and Naughton demonstrate that reform was not inevitable in the late 1970s.[36] The ending of the Cultural Revolution did not lead so much to liberalizing reforms as to an attempt to rebuild the planned economy. Indeed, it was natural for the post-Mao leadership to seek to revitalize the plan precisely because of the disruptions to planning sustained under Mao.

As mentioned earlier, however, the effort by Hua Guofeng and his planners to refurbish the plan and reenergize Chinese development fell apart under the weight of unrealistic assumptions. In response to the resultant economic crisis, the new economic leaders centered around Chen Yun launched an economic stabilization program that deemphasized heavy industry. Resources were instead redeployed to the household sector and light industry during 1979–81. Most importantly, economic stabilization, the reorientation of economic strategy, and the unexpectedly good agricultural harvests relieved the shortages that were characteristic of command economies. The slack economic environment resulted in a diminished role and desire for state redistribution and investment while successes in rural reforms unleashed desires for more re-

[35] This sketch of an argument is fleshed out in Dali L. Yang, *Calamity and Reform in China: State, Rural Society, and Institutional Change since the Great Leap Famine* (Stanford, Calif.: Stanford University Press, 1996).

[36] Dorothy Solinger, *From Lathes to Looms: China's Industrial Policy in Comparative Perspective, 1979–1982* (Stanford, Calif.: Stanford University Press, 1991).

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forms in other spheres of economic life. The era of reform was thus begun, without a blueprint, as a sideshow to economic reorientation.[37]

From Rationalization to Market Competition

It was not, however, that Chinese policymakers did not try to devise reform plans.[38] Naughton reminds us that during the December 1979–February 1984 period alone, the authorities drew up and adopted no fewer than seven reform programs, none of which specified what the comprehensive reform would be like. After all, while Chen Yun believed it was desirable to supplement the plan with the market, he and most economists and politicians could not even contemplate supplanting the former with the latter at this time.[39] In fact, through the mid-1980s, Premier Zhao Ziyang sought the implementation of rationalizing reforms rather than market-oriented ones. The objective of East European–style rationalizing reform was to have planners calculate and reset prices for state enterprises to the optimal, rather than leave it to market supply and demand to set prices. The goal, in other words, was to make the planned economy work better.

In practice, though, rationalizing reform worked well only on paper; the reformers were unsuccessful in their attempts to rationalize prices and financial relations in the face of vested interests that would be affected by each price realignment and the technical difficulties in computing "optimal" prices (Naughton, 129–30). As a consequence, industrial reforms turned by default to the expansion of enterprise autonomy and combining plan and market. Both measures were within the realm of rationalizing reform and thus unexceptional. But they legitimated the partial engagement of state enterprises in market activities, which became a necessity for many enterprises facing budget cuts, as well as the entry of new, particularly rural-based enterprises, which sprang up across the country to take advantage of state-protected high prices for various products, especially in light manufacturing. This was known as the dual-track system, in which plan and market elements coexisted and through which the Trojan horse of market-based competition was introduced.[40]

[37] Cyril Lin, "Open-Ended Economic Reform in China," in Victor Nee and David Stark, eds., *Remaking the Economic Institutions of Socialism: China and Eastern Europe* (Stanford, Calif.: Stanford University Press, 1989).

[38] An interesting look into this aspect of post-Mao China is Carol Lee Hamrin, *China and the Challenge of the Future* (Boulder, Colo.: Westview Press, 1990).

[39] Naughton points out bluntly that one major reason for the adoption of the gradual approach was "simply because so much time was *wasted* pursuing dead ends and even regressive policies" (p. 22).

[40] Naughton first told of this story and explored its implications in truncated form in "Implications of the State Monopoly over Industry and Its Relaxation," *Modern China* 18 (January 1992).

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The dual-track system was, however, prone to arbitrage activities: one could purchase certain products at plan prices and immediately resell them for a profit at the higher market price. It was essentially a form of institutionalized corruption and thus a major cause of social grievances in the 1980s. Nevertheless, unlike full conversion to the market, the dual-track system not only enriched the gatekeepers but was also acceptable ideologically. In hindsight, it served to further undermine the coherence of Chinese planning and propel state enterprises to the market.

For state enterprises had stood on artificial limbs. While the Chinese central government, unlike its Soviet counterpart, never possessed detailed control over industry and allowed local governments to operate enterprises independent of the central plan, it nevertheless ensured state industry profitability through government control over agricultural and other raw materials, and by limitations on the types of industrial activity local community governments could engage in (Naughton, 312). Through the industrial monopoly, the government made it possible for "urban firms [to have] cheap capital and expensive labor," even though China's factor endowments were exactly the reverse (p. 149).

In 1979 the central government began to encourage rural enterprise development so as to strengthen the soon-to-be-dismantled rural collectives (Naughton, 147–48). The removal of government-imposed barriers to entry was enthusiastically embraced by rural local governments eager to take advantage of the artificially high profitability of industry. What the government did not foresee was that the resultant rapid expansion of the nonstate sector, which has tended to grow where there was already urban industry, became the most potent force for China's transition to a market economy.[41] The entry of new nonstate producers greatly expanded the range of products and services available on the market and created competition for existing state firms. As the competitive pressures steadily increased and sellers' markets became buyers' markets, profit margins for firms of all ownership types steadily declined. In consequence, central government finance came under heavy pressure owing to its reliance on the financial health of state enterprises. The emergence and intensification of market competition thus accounts not only for the dynamism and international competitiveness of Chinese industry but also for the difficulties facing state en-

[41] While private and foreign-funded firms have become more important over time, most firms in the so-called nonstate sector are public enterprises funded by local community governments. See Andrew G. Walder, "Local Governments as Industrial Firms: An Organizational Analysis of China's Transitional Economy," *American Journal of Sociology* 101 (September 1995).

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terprises and central government finance. It is an economical and powerful explanation of the dynamics and dilemmas of the political economy of market transition in China.

In short, while the Chinese government was a major player in shaping the contours of the reforms, it did not plan or anticipate China's transition to the market until long after the reform process had started. Naughton thus sums up the pattern of Chinese reforms:

> The reform process has typically unfolded in ways very different from those envisioned by reformers in the early phases. . . . The Chinese approach is in some ways the path of least resistance, traced in an economic landscape by a political organism with limited abilities to map the terrain and chart a path on its own. (p. 24)

By emphasizing state incoherence, Naughton also answers a question that the rational choice approach may find disconcerting: given the interests and strength of the central ministries in maintaining their industrial monopoly, why were the nonstate sectors allowed to grow so rapidly as to threaten the state enterprises? Contrary to conventional wisdom, Naughton points out that central policymakers in 1979 did anticipate the rapid expansion of rural enterprises in the 1980s (p. 148). What they did not anticipate was the economy-wide implications of the expansion of the nonstate sector and especially of rural enterprise. Similarly, leaders of state industrial interests also appear to have failed to foresee the full and long-term consequences of a seemingly beneficial decision (strengthening rural development helped ensure raw materials for state enterprises) and in any case were reeling from the collapse of the ten-year plan and did not much object to the development of rural enterprises at this time.

With the sharp increase in the number of rural enterprises over the 1980s, they would come under vociferous criticism from urban interests.[42] Yet by the latter part of the 1980s the political landscape had changed. Provincial and local governments embraced rural enterprises for their contributions to the local economy. And since provincial governments were the equals of central ministries in the bureaucratic hierarchy, they effectively provided a political umbrella for these enterprises.[43] The reformers among the top Chinese leadership welcomed the rapid expansion of rural enterprises as a major achievement of the

[42] For a sampling of the debate, see Robert C. Hsu, *Economic Theories in China, 1979–1988* (Cambridge: Cambridge University Press, 1991), 125–30.

[43] Yingyi Qian and Chenggang Xu, "Why China's Economic Reforms Differ: The M-Form Hierarchy and Entry/Expansion of the Non-State Sector," *Economics of Transition* 1 (June 1993).

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reforms, particularly in light of the difficulties facing state enterprises. Even leaders of a conservative bent such as Premier Li Peng learned during 1988–90 that they needed the rural enterprises for the sake of economic and social stability.[44]

Market Integration versus Segmentation

While growing interfirm competition has been the major dynamic driving China's transition to a market economy, such competition need not occur if local economies are isolated from each other and local governments continue to intervene in the enterprise operation.[45] With fiscal decentralization, local governments have strong revenue and social welfare (especially employment) incentives to engage in *local protectionism*, a term that usually refers to two types of trade behavior. The A type (export embargo) seeks to keep locally produced resources for local processing when under market conditions such resources would have flowed out. Such behavior is obviously more likely to occur when demand for raw materials is rising fast during an economic boom and especially when prices of raw materials are kept artificially low by government fiat. The B type (import substitution) seeks to keep the local market open only to local producers by preventing products produced elsewhere from coming in even when imported products are of superior quality and better price. Such behavior is more likely to occur when there is a proliferation of similar products by firms supported by different local governments and when demand is depressed during an economic downturn.

There was much anecdotal evidence of the incidence of both types of local protectionist behavior in China, especially in the turbulent latter half of the 1980s. Chinese scholars argue that decentralization not only whetted the appetite of local governments for industrial expansion but also undermined integration of the nationwide market. Segmentation of the national market allegedly occurred because decentralization led to excessive and duplicative investment, and stimulated local protectionism or the formation of feudal-style economies.[46] Western scholars concurred. According to Christine Wong, fiscal decentraliza-

[44] Yang (fn. 35), chap. 8.

[45] For distinctions between two different types of decentralization (firm versus local government), see Franz Schurmann, *Ideology and Organization in Communist China* (Berkeley: University of California Press, 1968), 175–78, 196–99.

[46] Xue Muqiao, *Bashi niandai de zhongguo jingji* (The Chinese economy in the 1980s) (Beijing: Jingji guanli chubanshe, 1992), 24–26; Shen Liren and Dai Yuanchen, "Woguo 'zhuhou jingji' de xingcheng jiqi biduan he genyuan" (The formation, adverse consequences, and roots of "duke-style economies" in our country), *Jingji yanjiu* (Economic research), no. 3 (1990), 12–20.

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tion "induced [local] officials to intervene to protect the welfare of their enterprises whenever possible, perpetuating bureaucratic management and exacerbating the tendency toward regional protectionism." It consequently "hamper[ed] the development of national markets."[47] As Shirk forcefully asserted: "The balkanization of the Chinese market, which had begun under Mao Zedong's policies of regional self-reliance, was exacerbated greatly by the 1980 fiscal reforms." As a result, "the national market was segmented by administrative barriers" because local officials sought to protect local firms from outside competitors (p. 186; also pp. 153–54).

Was the Chinese market even more balkanized in the 1980s than it had been in the 1960s and 1970s? Has fiscal decentralization really led to market segmentation in China? Despite their apparent force, the arguments presented above were based on anecdotal evidence rather than on sound theoretical justification and systematic empirical measurements. In theory, each local government faces powerful incentives to engage in protectionist behavior even though trade would improve the collective welfare. It is thus possible that decentralization in a command economy of only a few local units may easily be turned into domination by local governments. But the same is much less likely in an economy of numerous local governments with porous borders that is governed by a central government intent on encouraging horizontal linkages and breaking down interregional barriers.[48]

As of the end of 1993, China had 30 provinces (average population: 39.5 million), 570 cities, 2,166 counties, and 48,200 town and township governments. In this continent-sized economy, a local government, whether a township or province, that is bent on market expansion outside and protectionism at home must contend with other localities that hold similar aspirations.[49] As Naughton writes of rural industry, although each of the local governments

> may have originally tried to operate a miniature state-run economy, the fact was that ultimately producers in each were subject to competition from thousands of

[47] Christine P. W. Wong, "Central-Local Relations in an Era of Fiscal Decline: The Paradox of Fiscal Decentralization in Post-Mao China," *China Quarterly*, no. 128 (December 1991), 694.

[48] For one interesting discussion of the difference size makes, see John P. Lewis, "Some Consequences of Giantism: The Case of India," *World Politics* 43 (April 1991).

[49] The dynamics of local government competition and emulation is discussed in Dali Yang, "Policy Credibility and Macroeconomic Control in China" (Paper delivered at the annual meeting of the American Political Science Association, Washington, D.C., September 1993). Personal interviews with municipal planning officials convey a palpable sense of competition. Planning officials often stressed to me that their planned projects should not be revealed publicly for fear that other localities might use such information to get ahead of them.

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other villages. In this fundamentally competitive environment, each township or village found that it faced a relatively hard budget constraint, and had to make its own enterprise economically successful. Rural enterprises created competition for state firms, but they were themselves ultimately shaped by the competitive process as well. (p. 158)

Because China made the transition to the market gradually, rather than in one-shot, one expects to find local government behavior passing through several overlapping stages as market forces grow stronger over time. Thus, local governments newly permitted to enter various industries will initially rush to invest in high markup industrial sectors, particularly sectors with low barriers to entry such as textiles and light industry. In the textile industry, for example, the number of enterprises rose from 12,145 in 1978 to 19,681 in 1984 and 48,747 in 1989.[50]

As new capacity goes into production and competition heats up, one expects local governments to turn instinctively to the bureaucratic protectionist behavior that they knew so well from their experience in a command economy. In the mid- to late 1980s, the turn to local protectionism was also exacerbated by the transitional dual-track price system.[51] For this reason it would seem that the cries of local protectionism, which rose to a crescendo in the late 1980s, can be better interpreted as indicators of intensifying market penetration and competition. The spread of capitalist competition has never been a neutral process.[52]

Over time intense competition brings down profit margins and forces factories to become competitive or face extinction. Local governments find that it no longer makes sense to keep local factories afloat if they cannot compete and make money. Some of them soon decide to get on the bandwagon of consolidation and cooperation. They induce mergers in sectors suffering from excess capacity and, in the case of the textile industry, have signed interregional agreements to transfer production capacity from high-cost coastal cities to Xinjiang, China's leading cotton-exporting area.[53] Local governments are chiefly concerned about absolute gains, not relative gains, and they can set up in-

[50] *Zhongguo fangzhi gongye nainjian* (China textile industry yearbook) (Beijing: Fangzhi gongye chubanshe, 1986–1991).

[51] For an interesting case study, see Andrew Watson, Christopher Findlay, and Du Yintang, "Who Won the 'Wool War'?" *China Quarterly*, no. 118 (June 1989); for a regional perspective, see Dali Yang, "Reforms, Resources, and Regional Cleavages: The Political Economy of Coast-Interior Cleavages in China," *Issues and Studies* 27 (September 1991).

[52] Karl Polanyi, *The Great Transformation* (Boston: Beacon Press, 1957).

[53] *Renmin ribao* (People's daily), overseas ed., September 30, 1995, p. 2.

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stitutions for interregional trade and cooperation much more easily than nation-states can.[54]

The question of whether the Chinese market is becoming more integrated or fragmented is ultimately an empirical one. The most significant though still preliminary study to deal with this question finds that as far as internal trade is concerned, the overall trend is ambiguous; while overall trade volume has risen, the increase in the ratio of trade volume to gross domestic product has lagged behind the economic growth rate. The study suggests, however, that the more prosperous coastal provinces have not only become more involved in international trade but may also have been able to develop stronger trade links, in terms of domestic exports, with other interior areas.[55] Nevertheless, the worst of interregional trade restrictions occurred during the 1987–90 boom-bust cycle owing to the adoption of various transitional measures, including partial price deregulation and large differentials in regional terms of trade and most of these transitional measures have since been removed in favor of market mechanisms. In consequence, the tide of local protectionism has clearly subsided in the 1990s. As both Chinese and multinational companies have found out to their delight, if you view and treat China as a national market, it is a national market, whether your products are soft drinks or diesel engines.[56] While the Chinese internal market is less integrated than that of more developed Europe or North America, it is nevertheless progressing in the direction of greater integration.

Beyond Reform: The Future of the Chinese Economy

Both Naughton and Shirk consider the gradualist approach to reform to be the path of least political resistance and in many respects the better alternative. Indeed, China's superior economic record justifies gradualism as a viable alternative to rapid, dramatic transition. In the words of Naughton, "By maintaining administrative coordination while allowing market coordination, the economy faces less risk of catastrophic failure" during gradual reform than when experiencing the shock of sudden, total change (pp. 309–10).

Unlike starry-eyed journalists and policy analysts, however, both

[54] For an overview of various types of interregional cooperation, see Dali L. Yang and Houkai Wei, "Rising Sectionalism in China?" *Journal of International Affairs* 49 (Winter 1996).

[55] Anjali Kumar, "Economic Reform and the Internal Division of Labor in China: Production, Trade and Marketing," in Goodman and Segal (fn. 14), 99–130, esp. 113, 125.

[56] *Wall Street Journal*, September 12, 1995, pp. 1, 6.

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Naughton and Shirk recognize that China's growth record has been less impressive than it appears, being more extensive than intensive. This is partly because China's reform approach and policies are generally second best, adopted for the sake of political expediency rather than optimal economic efficiency. In other words, gradualism skews the incentives environment for production and investment and distorts the allocation of scarce resources. First, inefficient factories are kept alive by government subsidies to keep workers employed, with political considerations operating as a major constraint on economic rationality. And second, the bureaucratic economy continues to build many factories and other facilities that will turn out to have little value once marketization is completed. Thus Naughton's (p. 321) searching question: "How much of the economic growth of the last decade will turn out to be useless, with conversion costs merely deferred until a later date?"

The ultimate question therefore is not whether China has been able to expand its output rapidly in the recent past but whether it can eventually outgrow its past and become an innovator in its own right. To be sure, China has already become a major manufacturing site for multinational corporations working hard to penetrate the Chinese market.[57] The products these companies turn out range from soft drinks to cellular phones, digital switching equipment, computer chips, and aircraft. Yet practically all of the plants utilize core technologies produced elsewhere, suggesting that China operates at the lower end of hierarchical global production networks.[58] Manufacturers come to China to lower production costs (and to sell) and therefore could have chosen other countries for their plants. Various commentators have pointed out that Chinese development has more in common with the experiences of Southeast Asia than with those of Japan and Korea.[59] For all the benefits multinationals bring to the host economy, the continuing replication of global production networks may mean that China cannot replicate Japan's industrial trajectory and rise to the top of the hierarchy.

Yet China differs significantly from the Southeast Asian countries.

[57] The amount of foreign investment is not a good indicator of foreign penetration of the Chinese market, however. Just under two-thirds of the foreign investment in China comes from Hong Kong and will therefore no longer be "foreign" by 1997; a substantial amount of this is also believed to be original mainland capital being funneled back into China via Hong Kong to take advantage of preferential policies for foreign investment. For the same reason, China's export figures should be viewed with caution because they report total value only. This grossly overstates Chinese export prowess in the case of products assembled from imported parts.

[58] For a provocative discussion of this topic, see Mitchell Bernard and John Ravenhill, "Beyond Product Cycles and Flying Geese: Regionalization, Hierarchy, and the Industrialization of East Asia," *World Politics* 47 (January 1995).

[59] *Economist*, June 24, 1995, p. 16.

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First, China's huge size confers certain advantages. After all, how many other countries with similar levels of development engage in practically the entire spectrum of industry—from textiles to machinery, aircraft manufacturing, and space launches? For all its backwardness, China already possesses a sizable internal research and development capability. There is an underlying tone of techno-nationalism in President Jiang Zemin's words to the 1995 National Science and Technology Congress, that certain technologies are not being sold to China, and in his exhortation to Chinese researchers to build their own. It therefore bears watching whether China can sustain and expand its efforts in industrial research and development and successfully translate research into market success.

Second, the *Economist* was plainly wrong when it stated matter-of-factly that China "is much less prone to try to second-guess the market through a government-directed industrial policy" than are Japan and South Korea.[60] Not only was Chinese industrial development directed and managed by the state prior to the reforms, but the state has continued to take a paternal interest in guiding industrial development. Throughout the reform period, even though the Chinese government has repeatedly found itself having to catch up with developments in the economy and "rarely had the ability to design and then carry out long-term, multi-stage reform programs" (Naughton, 23), it has persisted in steering investments into priority sectors on a scale that is the envy of Japanese planners.

The nature of government intervention has been changing, however. Toward the end of the 1980s, Chinese planners began to refashion their identity to suit an increasingly market-oriented economy. They started to replace traditional planning tools with new industrial policies in order to achieve macroeconomic stability and guide industrial development. Learning from the experiences of China's East Asian neighbors, Chinese planning agencies have become convinced that industrial policies furnish the appropriate tools for combining a market economy with continued state involvement. They are designed for the rationalization of industrial structure and the enhancement of China's industrial competitiveness in world markets through government guidance of the market. In other words, like its East Asian neighbors, the Chinese state now seeks to act "as entrepreneur, banker, and shaper of the industrial structure."[61]

[60] Ibid.

[61] Robert Wade, "East Asia's Economic Success: Conflicting Perspectives, Partial Insights, Shaky Evidence," *World Politics* 44 (January 1992), 285.

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China has so far formally promulgated two sets of East Asian–style industrial policies, one in 1989 and one in 1994. In terms of resource mobilization and allocation, an examination of the implementation of China's 1989 industrial policies concludes that these policies have had some effect in directing investment capital away from industries with excessive capacity and into areas deemed in need of more investment. Overall it has been found that government intervention in specific industries was more likely to be effective when the policies conformed to market trends.[62]

Efforts by the government to rationalize industrial organization are much harder to evaluate than investment flows. For better or for worse, the efforts to reorganize national industry are partly intended to help Chinese industry survive the onslaught of multinationals. Prominent Chinese lawmakers have expressed deep concern about foreign dominance in various industries, from soft drinks to aircraft manufacturing. Perhaps the most prominent initiative by the government to guide industrial organization was the Hualu-Matsushita Video Company. The company, founded with the blessing of Executive Vice Premier Zhu Rongji, represented a cooperative effort on the part of the central government and provincial authorities to avoid excessive capacity in VCR production. The company was authorized as the sole developer, producer, and seller of key VCR component parts in China. Yet owing to limited domestic demand and widespread smuggling, the company found itself burdened with rising inventory and forced to idle production capacity barely a year after its inauguration[63]—hardly the model of success envisioned by its planners.

While Hualu is not a typical case of industrial reorganization in China, a growing number of corporate mergers and acquisitions are taking place. Hundreds of enterprise groups have been formed in recent years and the Chinese government has designated one hundred of them for priority support. The government hopes that some of these enterprise groups will assume the role of the Japanese *Keiretsu* or Korean *chaebol* and spearhead increasing industrial competitiveness for China. Some of the changes are substantive. In the automobile industry, the government has made a strong commitment to support some of the producers and a rather credible threat that the markets will become more open by a certain target date. The government policy has has-

[62] Dali Yang, "From Command to Guidance: China's Turn to New Industrial Policies," *Journal of Asian Business* 11, no. 2 (1995).

[63] *China Daily* (Business Weekly), May 22, 1995, p. 6.

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tened the formation of strategic alliances between domestic producers and foreign partners in preparation for intensifying competition. Yet in other cases, enterprise groups aimed at salvaging dying plants are forced on successful companies by superordinate agencies. Both the hands of government and the discipline of the market are at work in shaping China's population of industrial firms. Yet again the leaders may want to lead but will find themselves unable to dictate the shape of things to come. In spite of its aggregate economic size, the Chinese economy will become world-class only when its firms become world-class. And indeed the names of a number of Chinese companies have already appeared in rankings of global companies.[64] Having navigated the transition to a market economy, however, China now has a reasonably fertile ground for the growth of competitive companies.

[64] An optimistic assessment is provided by Tisdell, who argues that "by having an appropriate policy for international cooperation and technology transfer, it should be possible for China to develop rather than 'de-develop'—that is, to avoid becoming trapped in a center-periphery situation." Clement Tisdell, *Economic Development in the Context of China: Policy Issues and Analysis* (London: Macmillan, 1993), 42.

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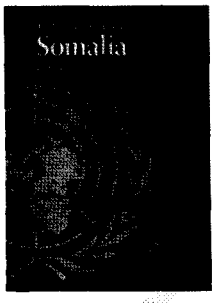

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